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No. .....

In the

Supreme Court of the United States

October Term, 1978

ROBERT E. and JANE ANN HARDEN CLEMENT,

Petitioners

v.

UNITED STATES OF AMERICA,

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Robert E. and Jane Ann Harden Clement petition for a writ of certiorari to review the decision of the United States Court of Claims in this case.

OPINIONS BELOW

The opinion of the Court of Claims (Appendix A, *infra*, pp. A-1 to A-21) is reported at 580 F.2d 422 (Ct.Cl. 1978). The report and conclusions of law of the trial judge of that court (Appendix B, *infra*, pp. B-1 to B-38) are reported at 77-2 U.S. Tax Cas. ¶9600 (Ct.Cl.Tr.Div. 1977).

JURISDICTION

The judgment of the Court of Claims was entered on July 14, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTIONS PRESENTED

1. Whether a farmer using the cash basis method of accounting may deduct in the year of purchase the entire cost of cattle feed which is not consumed until the next tax year (where a valid business purpose exists for both the purchase and its timing), even though the taking of the deduction in the year of purchase "materially distorts" the farmer's income for that year?

2. Whether the Commissioner of Internal Revenue has the authority to change a farmer's method of accounting for feed purchases from the cash basis method to a "consumption" or "inventory" method under the Internal Revenue Code and Treasury Department regulations as they existed on December 31, 1968?

3. Whether feed used to fatten livestock held for sale, which produce no income until sold, can be characterized for deduction purposes as "period costs" such as rent, interest and insurance premiums, which are fixed liabilities payable in fixed, periodic installments?

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE. — Taxable income shall be computed under the method of accounting on the basis of which

the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS. — If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) PERMISSIBLE METHODS. — Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting —

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE. — The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

SEC. 471. GENERAL RULE FOR INVENTORIES.

Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Treasury Regulations:

§ 1.162-12. Expenses of farmers.

(a) Farms engaged in for profit. A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming.... The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. (Remaining portions omitted.)

§ 1.471-6. Inventories of livestock raisers and other farmers.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

STATEMENT

The trial judge's findings of fact[1] establish that the petitioners were bona fide partners (10.9% interest) in a bona fide California partnership organized in 1968 for the purpose of engaging in the business of buying, feeding and selling cattle for profit (App. B-23), which business is classified as "farming" under the Internal Revenue Code and the Treasury Regulations issued pursuant thereto (26 U.S.C. § 61; Treas. Reg. § 1.61-4[d]).[2]

The partnership and the petitioners reported income and expenses for tax purposes on the cash receipts and disbursements method of accounting and on a calendar year period. (App. B-23)

[1] The trial judge's findings of fact were adopted by the reviewing panel. App. A, p. A-2.

[2] See, also, *Hi-Plains Enterprises, Inc. v. Commissioner*, 496 F.2d 520 (10th Cir. 1974), where under identical circumstances the U.S. Court of Appeals held such partnerships to be "farmers" for purposes of the income tax laws.

Prior to December 31, 1968, the partnership negotiated for the purchase of cattle to be delivered to various feedlot locations in California and Nebraska. The total number of cattle ultimately purchased was 4,268 head, actual delivery of which commenced in January, 1969, and was completed in July, 1969. (App. B-24 - B-27)

Prior to December 31, 1968, the partnership expended $311,548.00 for the purchase of specific cattle feed ingredients for consumption by the 4,268 head of cattle and obtained warehouse receipts for all of the feed so purchased. Payments for the feed were paid and cleared through the partnership's bank account prior to December 31, 1968. *(Id.)* The Court of Claims found that a valid business purpose existed for both the purchase and the timing of the purchase. (App. A-12, A-14)

The cattle owned by the partnership eventually consumed in 1969 an amount of feed "roughly equivalent" to the amount purchased in 1968. (App. B-28)

On the partnership's information return for the year ending December 31, 1968, the partnership reported the feed purchases as a "farming expense" which resulted in a net loss for the year under the cash receipts and disbursements method of accounting which it had elected to use.[3] (App. B-29, 30)

The petitioners reported their proportionate share (10.9%) of the partnership loss ($33,959.00) as a deduction on their individual income tax return for the calendar year 1968. *(Id.)*

The Commissioner of Internal Revenue disallowed the $33,959.00 deduction. The petitioners paid the deficiency, timely

[3] Pursuant to Treas. Reg. § 1.471-6(a), the partnership had the option to make its tax return using the inventory method or cash receipts and disbursements method of accounting and elected to use the cash method.

claimed a refund of $14,170.00, (App. B-23, 24) and timely filed this suit for refund in the Court of Claims on April 21, 1975, pursuant to 28 U.S.C. 1491 and 26 U.S.C. 6402. The case was tried in San Diego, California, on June 15, 1976, before Trial Judge David Schwartz. The trial judge filed a written opinion with Findings of Fact and Conclusions of Law on August 19, 1977, and entered a judgment for refund in favor of petitioners.

The Court of Claims, despite its finding that a valid business purpose existed for both the feed purchase and the timing of the purchase, reversed the trial judge's decision on July 14, 1978. In holding that the Commissioner did not abuse his discretion under I.R.C. § 446 in disallowing the feed deduction in 1968, the Court of Claims adopted the position that requiring the feed expense to be deducted when the feed was consumed did not impose an inventory method of accounting upon the petitioners who had properly elected[4] to use the cash method instead of inventories. To reach this result the Court of Claims equated farm supplies with "period costs" such as rents, insurance premiums and interest, and relied upon cases which have allowed the Commissioner to require cash basis taxpayers to prorate such expense deductions over the period of the cost's utility.[5]

Petitioners' position throughout these proceedings has been that farm supplies are not "period costs", and that, unlike the simple calculation required to prorate rents, insurance premiums and interest over a term, accounting for the cost of farm supplies on a consumption basis requires farmers to maintain inventories, a

[4] See footnote 3, *supra*.

[5] The case authorities relied upon by the Court of Claims in this regard did not involve farm supplies such as feed, seed and fertilizer and did not discuss the special rule for farmers contained in Treas. Reg. § 1.471-6(a).

requirement contrary to Treas. Reg. § 1.471-6(a). Petitioners recognize that the cash method of accounting, by definition, does not match income and expense items for tax reporting purposes which may result in distortion (particularly when the standard for clearly reflecting income is the accrual method of accounting). However, "[t]he sacrifice in accounting accuracy under the cash method represents an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting system", a concession recognized and approved by this Court in *United States* v. *Catto*, 384 U.S. 102, 116 (1966).

REASONS FOR GRANTING THE WRIT

The Court of Claims, erroneously in our view, has allowed the Commissioner of Internal Revenue to change a farmer's method of accounting for purchases of farm supplies. This decision affects every cash basis farmer in the United States and effectively denies farmers the right to elect the cash method of accounting, a right expressly granted by Treas. Reg. § 1.471-6(a). The issues raised here are of major importance to the administration of the tax laws; the court below has decided a federal question in a way in conflict with an applicable decision of this Court; and the decision below conflicts with that of a United States Court of Appeals.

1. *Importance to the administration of the tax laws.* In the Tax Reform Act of 1976, Congress created a new category of farmers called "farming syndicates". Under new Section 464(a) of the Internal Revenue Code "farming syndicates" must deduct the cost of certain farm supplies in the tax year when used or consumed. New Section 464(a) (effective for tax years beginning after December 31, 1975) provides:

> GENERAL RULE. — In the case of any farming syndicate (as defined in subsection (c)), a deduction (otherwise allowable under this chapter) for amounts paid for feed, seed, fertilizer, or other similar farm supplies shall only be allowed for the taxable year in which such feed, seed, fertilizer, or other supplies are actually used or consumed, or, if later, in the taxable year for which allowable as a deduction (determined without regard to this section).

The legislative history of the Tax Reform Act of 1976 reveals that Congress intended to achieve a specific goal by the enactment of new § 464(a). That goal was to prevent the use of the "special tax rules" available to "full-time farmers" by "high-bracket taxpayers who participate in farming as a sideline." SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1976, S. Rep. No. 94-938, 94th Cong. 2d Sess. 51-54 (June 10, 1976). Congress clearly recognized the special rules for farmers then existing in the tax laws and changed the rules regarding the timing of deductions for farm supplies only with respect to "farm syndicates" and only for tax years beginning after December 31, 1975. *Id.*

The Court of Claims interpreted the legislative history of the Tax Reform Act of 1976 in precisely the opposite fashion, rejecting the notion that Congress had changed the law with respect to certain types of farmers and left the law unchanged with respect to less sophisticated farmers. Instead, the Court of Claims found that the committee reports "do not suggest that Congress was changing the law" (App. A-21, n. 12), and concluded that the Commissioner had had the discretion, even prior to the Tax Reform Act of 1976, to disallow farmers' deductions for feed in the year of purchase.

Thus, while it is clear that the partnership involved in this case would now fall within the new definition of a "farming syndicate",

it is equally clear that the Court of Claims' decision is not restricted to "farming syndicates" nor to tax years beginning after December 31, 1975. If the decision below is allowed to stand, all farmers could be required to maintain complicated, expensive inventory procedures to account for farm supplies on a "consumption" basis. With respect to farmers who are not "farming syndicates", such a result clearly contradicts the intent of Congress. With respect to farmers who are "farming syndicates", the result improperly applies the new rule contained in the Tax Reform Act of 1976 retroactively. For the tax year 1968, petitioners, like all farmers, were entitled to elect the cash receipts and disbursements method of accounting. The decision below denies petitioners, and all other farmers, this "historical concession." *U.S.* v. *Catto, supra.*

2. *Conflict with a decision of this Court.* In *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944), this Court construed Section 43 of the Internal Revenue Code of 1939, the predecessor to Section 461 of the Internal Revenue Code of 1954, which controls the timing for the taking of deductions. Section 43 provided:

> The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, *unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.* (Emphasis added.)

In *Security Flour Mills* this Court refused to apply the "distortion of income" test in Section 43 to an isolated transaction even though not to do so would result in an unfair distortion of income for a particular annual period. With respect to congressional intent

regarding Section 43 this Court stated that the requirement to "clearly reflect the income"

> ... was [inserted] to take care of fixed liabilities payable in fixed installments over a series of years ... [and] ... was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer.

321 U.S. at 285-86.

The court below dismissed this Court's decision in *Security Flour Mills* in a footnote, stating: "... it is now settled ... that the Internal Revenue Service has discretion to disallow a particular deduction on the ground that the timing of that payment distorts income. We do not believe that this rule, as applied here, conflicts with *Security Flour Mills Co. v. Commissioner* ..." (App. A-20, n. 10.) The effect of the decision below is to allow the Commissioner the discretion to take a "cash payment" "out of the annual accounting system and, for the benefit of the Government" treat it "on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government" in direct conflict with the admonitions of *Security Flour Mills.*

If the Commissioner is permitted to impose on a cash basis taxpayer a different accounting treatment for *any* item (as distinguished from items such as rent, insurance premiums and interest, which are fixed liabilities payable in fixed installments over a term) because in his opinion accounting for the item under the

cash method distorts income, the holding in *Security Flour Mills* must be disregarded.

3. *Conflict with a decision of a Court of Appeals.* Relying upon this Court's decision in *Security Flour Mills, supra,* the Court of Appeals in *Cravens v. Commissioner,* 272 F.2d 895 (10th Cir. 1959), refused to apply the distortion of income test to a farmer's prepaid feed expense and approved the deduction for the feed expense in the year of purchase, even though the feed was consumed in subsequent years. In *Cravens,* the Commissioner asserted that the taking of the deduction in the year the feed was purchased would violate §43 of the Internal Revenue Code of 1939 (the predecessor to § 461 of the Internal Revenue Code of 1954) because it would result in a distortion of the taxpayer's income for that year. Rejecting that argument the court stated:

> In the case of farmers and cattle raisers the use of a transactional basis for the computation of income would bring confusion into the federal tax system. The treatment of the cost of seed, fertilizer, and feed purchased in one year for the use in the next year is simple if the deduction is allowed when paid if the cash basis is applied or when incurred if the accrual basis is used. *If each transaction must be analyzed to determine whether a distortion of income will result from the allowance of a business expense deduction, Section 43 is, in our opinion, given a meaning which Congress did not intend.* (Emphasis added.)

272 F.2d at 900-901.

The *Cravens* court also rejected the Commissioner's argument that the prepaid feed purchase amounted to a capital investment, noting that the feed payment "was not for an addition, a betterment, or an advantage of a permanent character ..." 272 F.2d at 899. The Court of Claims, however, reached exactly the opposite conclusion, viewing the feed as a capital *asset* deductible,

if at all, only when used. (App. A-18, 19) The Court of Claims disregarded Treas. Reg. § 1.162-12(a), a special rule for farmers, which provides: "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay..."

To further support its decision the Court below relied upon *Commissioner v. Boylston Market Ass'n.*, 131 F.2d 966 (1st Cir. 1942), as authority for the Commissioner to require a cash basis taxpayer to prorate expense deductions which are "period costs". That case involved the timing for deducting insurance premiums prepaid by the taxpayer. In *Cravens*, the court noted that such expenses were fixed liabilities payable in fixed installments and distinguished *Commissioner v. Boylston Market Ass'n.*, specifically finding that feed purchases were not "fixed liabilities payable ordinarily in periodic installments." 272 F.2d at 899. Moreover, the proration of period costs such as rent, insurance premiums and interest over the period of utility provides an accurate matching of expense to income. Treatment of a product cost, such as feed, as if it were a period cost, does not result in such matching since product costs are inextricably related to the earning process consummated only upon the sale of the final product.

Both the result and reasoning in *Cravens* directly conflict with the decision of the Court of Claims in this case. Other courts have, likewise, reached decisions concerning the timing of feed purchase deductions directly opposite the result below. *Auburn Packing Co., Inc. v. Commissioner*, 60 T.C. 794 (1973); and *Gaddis v. United States*, 330 F.Supp. 741 (S.D. Miss. 1971); both dealing with the Internal Revenue Code of 1954. The Tax Court in *Auburn Packing Co.* recognized the

apparent conflict between the "clearly reflect income" standard imposed by § 446 of the Code and the special rules for farmers in the Regulations, and concluded that the special rules for farmers prevailed to allow feed purchases to be deducted when paid for under the cash method. See, also, *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973); and *Ernst v. Commissioner*, 32 T.C. 181 (1959) (Acq. 1959-2 Cum. Bull. 4). The result below is opposite the result in every other case which has reached or discussed the timing of feed purchase deductions by farmers.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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October, 1978.

APPENDIX A

In the

United States Court of Claims

No. 131-75

(Decided July 14, 1978)

ROBERT E. and JANE ANN HARDEN CLEMENT v.
THE UNITED STATES

Charles A. Pinney, Jr., attorney of record, for plaintiff.
James L. Malone III, with whom was *Assistant Attorney General M. Carr Ferguson*, for defendant. *Theodore D. Peyser, Robert S. Watkins*, and *Michael J. Dennis*, of counsel.

Before DAVIS, KUNZIG and BENNETT, *Judges*.

OPINION

PER CURIAM: This is an income tax refund suit in which the issue is whether the taxpayers, limited partners in a cattle-feeding partnership, were entitled under the law as it stood in 1968 to deduct the cost of cattle feed bought in one year and consumed in the following year, as an ordinary and necessary business expense in the year of purchase. The Commissioner of Internal Revenue disallowed the $33,959 sought to be deducted, the taxpayers paid the deficiency and claimed a refund of $14,170, and this action followed the denial of the claim.

Trial Judge Schwartz, who held for the taxpayers, passed on three issues: (1) whether the prepayment for the feed in the purchase year was made for a business purpose and not for tax avoidance;[1] (2) whether allowance of the deduction for the feed in the purchase year would result in a material distortion of income; and (3) whether, even if there would be such a material distortion of income, the taxpayers were nevertheless entitled as farmers to deduct the feed-prepayment in the purchase year. The trial judge held, first, that the prepayment was made for a business purpose; this determination is accepted by the defendant and not challenged before the court. The second holding in the Trial Division was that the prepayment would in fact result in a material distortion of income; this ruling is now accepted and not attacked by the taxpayers before the court. The only ruling of the trial judge which is disputed before us is that, despite the material distortion of income, taxpayers were nevertheless entitled as farmers to deduct the prepayment in the year of purchase.[2] On that ultimate question we differ from the trial judge.

In *Part One* of this opinion, *infra*, we adopt and set forth those portions of the Trial Judge Schwartz's opinion which are accepted by both parties *(see* note 2, *supra), i.e.* the statement of the facts[3] and of the issues, the decision on business purpose, and the determination that there would be material distortion of income if taxpayers were permitted to deduct the feed-prepayment in the purchase year.

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[1] It was conceded by the Government that the prepayment was a payment and not merely a deposit.

[2] Taxpayers accept the entire opinion of the trial judge and ask us to adopt it. The Government accepts all except the concluding portion of the trial judge's opinion in which he holds that, despite the material distortion of income, taxpayers could deduct the whole prepayment in the year the feed was bought.

[3] The necessary findings of fact are contained in this opinion.

In *Part Two* of the opinion, *infra*, we discuss the reasons why, in our view, the deduction is not allowable, given the now-unchallenged finding of material distortion of income.

PART ONE

The Facts. The plaintiffs together constituted one of 10 limited partners in a California partnership known as Vanderbilt Group No. 2.[4] The partnership was organized under an agreement filed on December 1, 1968, to engage in the business of buying, feeding and selling cattle. The taxpayers contributed $35,000 to the partnership's initial capitalization of $321,000, entitling them to a 10.90342 percent share in the partnership profits and losses.

The partnership agreement provided that the single general partner should enter into a "Cattle Feeding Advisory and Services Agreement" with a Mr. R. C. Chapman, of Whittier, California, doing business as the Whittier Cattle Company. The agreement with Mr. Chapman, made in December 1968, vested him with management of the partnership's operations. He was authorized to propose cattle and feed investment programs, buy and sell both feed and cattle, locate feedyards for cattle and arrange the feeding, keep the partnership's accounts and manage its daily business.

Acting in his capacity as managing agent, Chapman on December 27, 1968 purchased $311,548 worth of cattle feed for the partnership in three lots:

1. 98,400 bushels of No. 2 yellow corn at $1.23 per bushel, a total of $121,032, bought from Cargill, Inc., Omaha, Nebraska, to be delivered to the Cargill warehouse at Omaha, Nebraska;

---

[4] The parties have stipulated that both plaintiffs, Robert E. and Jane Ann Harden Clement, husband and wife, were limited partners in the partnership. The record indicates that only Mrs. Clement invested and participated in the partnership. Her profits and losses, however, were reflected in the joint tax return jointly filed by both husband and wife.

2. 2,563 tons of milo at $1.82 per hundredweight or $36.40 per ton, a total of $93,298, bought from Western Beef Grain Co., Amarillo, Texas, to be delivered to the Alamo Feed Yard, Calpatria, California; and

3. 1,980 tons of milo at $49.10 per ton, a total of $97,218, bought from Cargill, at Omaha, Nebraska, to be delivered in California between January and March 1969.

The purchase price was paid and the check cleared before the end of the year. The grain purchased was in existence; the partnership obtained warehouse receipts for the entire amount. The purchase of grain was the partnership's only business transaction in 1968.

The partnership filed an information return for 1968, reporting a gross profit of zero, a deduction of $311,548 on account of the purchase of grain and thus a net loss of $311,548. The plaintiffs' 10.9 percent share of the loss was $33,959, the only loss in the adjusted gross income they reported in their cash basis joint return for 1968. The loss reduced their otherwise gross income from $76,009 to $42,051. The return showed the following gains and partnership loss:

Dividends	$17,587
Interest	4,993
Rental property income	5,902
Trust Income	17,820
Operation of hobby shop	3,959
Sale/exchange of property	23,948
Miscellaneous (trustee fee)	1,800
Vanderbilt No. 2 loss	(33,959)
Adjusted Gross Income	$42,051

The adjusted gross income of $42,051 was reduced by deductions and exemptions to a taxable income of $26,865. As already noted, the Commissioner's disallowance of the loss of $33,959 is the basis of the present suit.

Chapman began to purchase cattle shortly after the beginning of the new year. It took about 2 weeks after the transaction for the cattle purchased to be delivered to the feedlot. While the dates of purchase are not clear on the record, cattle began arriving at the designated feedlots on or about January 15, 1969. The 4,268 head of cattle bought by the partnership arrived in 17 lots at the following dates between January and July 1969:

January 15, 1969	573 head
January 17, 1969	124
January 23, 1969	92
March 24, 1969	100
March 28, 1969	121
April 21, 1969	146
April 22, 1969	116
April 24, 1969	248
May 23, 1969	352
May 26, 1969	372
May 28, 1969	279
June 2, 1969	244
June 5, 1969	187
June 20, 1969	1,113
July 10, 1969	170
July 14, 1969	10
July 28, 1969	21
	4,268 head

In the spring, Chapman exchanged the warehouse receipts for 44,000 of the 98,400 bushels of the partnership's corn in Omaha, for the same amount delivered to an Oakland, Iowa feedyard, on payment of a transportation differential. Thereafter, he sold back to his vendor, Cargill, the receipts for the remaining 54,400 bushels at Omaha for $1.2475 per bushel, less a storage charge of .0036 cents per bushel, and bought 55,000 bushels at Grand Island, Nebraska, for $1.22 per bushel.

The cattle owned by the partnership eventually consumed an amount of feed roughly equal to the amounts first purchased in

the prior December, plus additional feed bought in 1969 at a cost of $59,429. Some small amounts of milo and corn were apparently left over and sold to feedyards, and the proceeds were reported as income. The partnership's gross profit on the sale of the feed cattle in 1969 was $271,936. Its information return in that year showed a gross profit in that amount, expenses of $130,340 and a net profit of $141,596, of which the plaintiffs' 10.9 percent share was $15,439.

Despite a profit from Vanderbilt No. 2 of $15,439, the taxpayer-plaintiffs' adjusted gross income was reduced by substantial losses from other investments to $4,423, as follows:

Dividends	$ 9,937
Interest	3,018
Rental property income	3,976
Trust income	19,670
Trustee fee	1,800
Operation of hobby shop	817
Sale/exchange of property	15,880
An unrelated business loss	(17,779)
Oil well investment expenses	(48,333)
Vanderbilt No. 2 income	15,439
Adjusted Gross Income	$ 4,423

Deductions and exemptions reduced taxable income to zero, actually a loss.

In 1970 the partnership in its information return reported a gross profit of $104,379 from the sale of cattle and feed, expenses of $46,424, including $29,875 for grain, and a net profit of $57,955, of which profit the plaintiffs' share was $6,345.

In 1970 the plaintiffs' adjusted gross income was $10,338, reflecting the profit of $6,345 from Vanderbilt No. 2 and further substantial losses in an oil well venture, as follows:

Dividends	$ 2,614
Interest	3,206

Rental property income	4,517
Trust income	19,810
Trustee fee	1,800
Operation of hobby shop	1,917
Sale/exchange of property	(1,000)
Partnership income (other than Vanderbilt No. 2)	615
Loss from oil well investment	(29,485)
Vanderbilt No. 2 income	6,345
Adjusted Gross Income	$10,338

Deductions and exemptions again, as in 1969, reduced the taxable income to zero, actually a deficit of $518.

The Issues. The issues requiring decision involve the application to the facts of the instant case of three tests for deductibility stated in Revenue Ruling 75-152, 1975-1 CUM. BULL. 144. In that Ruling, the Commissioner takes the firm position that a farmer who keeps his books under the cash receipts and disbursements accounting system may deduct, in the year of payment, the cost of feed which will be consumed in the following year, only if the three conditions are met:

> . . . (1) the expenditure is for the purchase of feed rather than a deposit, (2) the prepayment is made for a business purpose and not for tax avoidance, and (3) the deduction will not result in a material distortion of income.

Furthermore, the first two conditions must be fully satisfied before consideration of the deduction's effect on income is proper. The first condition — that the expenditure be a purchase and not a deposit — is met on the facts, and is not in issue. The second and third conditions raise contested issues: whether the expenditure was made for a business purpose and whether the deduction materially distorted income.

The Business Purpose of the Purchase. The Government contends that the partnership's 1968 expenditures had none of the

characteristics of a business purpose. In response, plaintiffs urge that a business purpose is not a prerequisite to deductibility where the prepayment is made pursuant to a binding contract and is not merely a deposit. Moreover, plaintiffs maintain that if a business purpose is required, it was present, because the costs of the advance purchases of feed were "ordinary and necessary expenses" of the partnership's cattle feeding business and deductible under the provisions of I.R.C. § 162(a).

A classic formulation of what is a deductible "necessary" business expense under I.R.C. § 162(a) is an expenditure that is "appropriate and helpful" in the accomplishment of the taxpayer's trade or business, while a deductible "ordinary" business expense is identified by reference to expenditures of the business community to which the taxpayer belongs. *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933). Actual outlays for feed are ordinary and necessary, for they are entirely appropriate and helpful in the carrying on of the business of feeding cattle. Treas. Reg. § 1.162-12, T.D. 6548, 1961-1 CUM. BULL. 63.

The Government's contention as to business purpose goes, however, not to the thing bought, but to the timing of its purchase. The primary purpose of the decision to buy feed in December 1968, rather than in 1969 when it would be needed, the Government says, was not business benefit but tax avoidance. Business purpose would be conceded for a purchase in December of enough feed solely for the cattle soon to be delivered. Business purpose is contested for the purchase in December of feed for cattle bought in the following March and thereafter.

Plaintiffs assert that if a payment for cattle feed is more than a deposit — that is, if it is an actual purchase — its timing need not have a business purpose. Reliance is put on *Mann v. Commissioner*, 483 F.2d 673, 680 (8th Cir. 1973) in which an outlay in advance of need, made pursuant to a binding contract, was held deductible.

There the court wrote that it found no "substantial support in the cases" for the Government's contention "that a benefit to the taxpayer is necessary to support the timing of a business expense deduction which meets the terms of § 162(a) in a situation where . . . payment is made pursuant to a binding contract." *Id.* at 680. The court went on, nevertheless, to find a business purpose; the purchase was held to benefit the taxpayer because it fixed a maximum price for feed, obtained for him a preferred position in case of a shortage, and assured known feed costs before the scope of the operation was determined. Accordingly, the court commented that the "issue need not be decided to resolve this case in light of our determination that a benefit to the taxpayer has been established." *Id.* at 680.

Other cases cited for the dispensability of a business purpose also found a business purpose in fact. In *Gaddis v. United States*, 330 F. Supp. 741, 750 (S.D. Miss. 1971) the prepayment was intended to forestall the impact of a possible rise in prices and feed shortage. In *Cravens v. Commissioner*, 272 F.2d 895, 897 (10th Cir. 1959) drought prompted the taxpayer to act to avert a feed shortage. Only in *Ernst v. Commissioner*, 32 T.C. 181, 185-86 (1959) did the court fail to find a business purpose, but there the issue was framed solely in terms of whether the prepayment was a deposit, and the court held the feed purchase expense incidental to carrying on a trade or business under section 162(a). There is, therefore, little authority for the proposition that an actual outlay for feed, not a deposit, may be deductible though made a year before it is needed, without regard to its lack of a business purpose. Acceptance of the proposition would confront the policy that tax consequences should be based on business reality and not on mere events created to avoid taxes. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Waterman S.S. Corp. v. Commissioner*, 430 F.2d 1185, 1193 (5th Cir. 1970), *cert. denied* 401 U.S. 939 (1971); see also *Welch v. Helvering*, 290 U.S. 111 (1933). As in *Mann v. Commissioner*, *supra*, 483 F.2d at 680, however, the present case does not require

a decision on the proposition, for as will be seen, there is evidence here of business purpose.

A number of factors may demonstrate a taxpayer's legitimate business purpose in prepaying for feed not consumed until the next tax year. Fixing a maximum price, obtaining a guaranteed supply to avoid the effects of a feed shortage, and obtaining advantages in the negotiation of storage and delivery terms are some of such factors. See *Mann v. Commissioner*, 483 F.2d at 679-80; *Cravens v. Commissioner*, 272 F.2d at 899-900; *Gaddis v. United States*, 330 F. Supp. at 750; Rev. Rul. 75-152, 1975-1 CUM. BULL at 144. If the taxpayer has a reasonable expectation of a business benefit when he purchases feed in the year prior to consumption, then the prepayment has served a legitimate business purpose. REV. RUL. 75-152, *supra*.

The Government asserts that Vanderbilt No. 2 was not motivated by any reasonable expectation of a business benefit when it purchased grain in December 1968; that the partnership acted in haste and without a business plan for feeding operations, in order to create a deduction in 1968; and that the changes in the feeding plan in 1969 — the 1969 resales and movement of the corn bought in 1968 — indicate the actual lack of a feeding plan in 1968 and refute the plaintiffs' claim of legitimate business motivation in 1968.

The plaintiffs' response is essentially Mr. Chapman's testimony on trial that all his operations in 1968 and 1969 were according to an original plan, or amendment consistent with his original plan, to obtain an economic benefit. Chapman, who is an agricultural economist and has had considerable experience in the cattle business, testified as follows: In December 1968, he decided on the number of cattle he would feed and upon the general locations at which he would feed them — California and Oakland, Iowa, the closest feedyard to Omaha. He chose the Omaha area because it

was one of the lowest priced feed markets and was expanding its packing plant capacity, thus assuring a demand for cattle. By thus increasing the partnership's business in a growing area, Chapman expected to avoid complete dependence on California markets.

Mr. Chapman explained his exchanges of Omaha corn for corn delivered at Oakland, Iowa, and his sale of Omaha corn and purchase of the same amount in Grand Island, Nebraska. Though he would purchase grain in Omaha, the location with the largest storage capacity and lowest prices, his first intention was to feed the partnership's midwest cattle in the feedyard closest to Omaha, which was in Oakland, Iowa. That yard, however, had only a limited capacity to store grain. He was aware, at the time he purchased the grain in Omaha in December, that he would have to pay a transportation differential to transfer the grain from Omaha to the feedyard in Oakland, as he did in fact in April 1969. The subsequent transfer of part of his feeding operation from Oakland to Grand Island, Nebraska, was in accordance with his practice in managing cattle feeding ventures, which was to shift yards when better terms were offered. He made the change, he said, in response to a better economic arrangement at the Harrington Feed Yard in Grand Island.

Chapman testified to economic justifications for the purchases in December. He explained that his studies had shown that in 8 of 10 years, grain was cheapest in the fall. Because prices tended to rise significantly in the spring, he wanted to fix his costs in December. Purchases in December also assured a sufficient supply of grain to feed the number of cattle that he planned to buy.

Continuing, he testified that the premium paid to obtain warehouse receipts (which normally sell at a premium of 1 to 5 cents because of their value as a warranty of the nature of the grain) was a hedge against the possibility of unexpected shortages. Having decided that feeding would take place in California and eastern Nebraska/western Iowa, his purchases in December served to assure

that the grain would be in his planned general location when actual feeding began. By committing the partnership in 1968, he was also able to negotiate favorable storage rates, eliminating such charges entirely in some instances and incurring only partial charges in others.

A second witness for plaintiff, Mr. Leon Miller, also testified to the reasonableness of the partnership's 1968 purchasing decision. Mr. Miller is a California cattle marketer and grain trader with experience in the cattle feeding business. He testified that it is a common practice in the Southern California cattle industry to purchase feed in the year prior to consumption, to ascertain the total cost of feeding the cattle, to protect against increased costs, and to help in obtaining favorable storage rates.

The Government's response to Messrs. Chapman and Miller is based entirely upon the testimony of its expert witness, Mr. Jack Ross, a feed grain analyst for the Economic Research Service of the United States Department of Agriculture. Citing forecasts of the Department which he had helped to prepare in the fall of 1968, Mr. Ross described the grain market at that time as one of ample supply and moderately rising demand with generally stable prices, except for an anticipated normal seasonal price rise of about 15 cents a bushel. Corn, he said, is the most significant factor in the grain market, because it is the dominant feed grain produced. The Department of Agriculture forecast a supply of 5.6 billion bushels of corn with total demand expected to equal 4.5 billion bushels. The market was very stable, he testified, with the Government controlling sufficient reserves to prevent any distortions. He concluded that in the market then existing, it was unnecessary and unreasonable for the partnership to purchase such large amounts of feed in December 1968, prior to the acquisition of its cattle in the spring of 1969.

The December purchases are held, on a weighing of the testimony of the opposing witnesses, to have had a business purpose.

Mr. Chapman did assure himself of a supply. He did fix prices, thereby learning the scope of his costs for feed. His explanation of his movements of corn and feedlots in 1969 is credible and rebuts the Government's claim that his 1969 dealings in feed show haste and lack of planning in the purchases in December 1968, and nullify the price advantages Mr. Chapman obtained by purchasing before the seasonal advances in price. The Government has also argued that if the Grand Island price of $1.22 did not include the customary premium of 1 to 5 cents for warehouse receipts instead of actual feed, then the May price was higher than the December Omaha price, which had included a premium for the guarantee represented by the warehouse receipts acquired. This is a small and speculative point. In fact, Chapman paid $1.23 per bushel to Cargill in Omaha in December, sold receipts for 54,400 bushels back to Cargill in the spring for $1.2475, less .0036 cents for storage, or a net cost of $1.2439, and bought 55,000 bushels in Grand Island for $1.22 per bushel, a total net profit of 0.0239 per bushel, or a total net profit of $1,300.16 on the 54,400 bushels first bought (.0239 X 54,400). The exchange of 44,000 bushels of Omaha corn for Oakland corn in April 1969 cost Chapman a transportation differential of .06 cents per bushel or a total of $2,640. But, he testified, it was part of his original plan to buy in Omaha and feed in Oakland. Chapman said that he expected in December that his prices then would be the maximum he would pay, and he seems to have been right.

There is not enough to the Government's case to overcome the convincing testimony of Mr. Chapman of the business reasons for his decision to buy in December, supported by the testimony of the additional witness that Chapman was following the common practice of breeders and cattle feeders in Southern California. The Government's evidence as to the Department of Agriculture forecasts may be accepted in full and yet it was Chapman's privilege to plan and buy as he did, for the reasons he gave. The businessman is allowed discretion to make business judgments. The Govern-

ment's expert is neither a cattle breeder nor feeder nor grain buyer. He did not testify as to trade practice in Southern California or elsewhere, or trade reliance on his forecasts. Neither his forecasts nor hindsight in recounting the failure of prices to rise or shortages to develop negative the partnership's motive in its opening days to assure a supply of feed at a known price and thereby to fix the costs for feed before undertaking the required major outlays for cattle. The totality of the evidence establishes a business purpose under the authorities already cited, and this condition for deductibility is met.

The Material-Distortion-of-Income Standard. Revenue Ruling 75-152, 1975-1 CUM. BULL. 144, imposes, as well as the business purpose test, the condition upon deductibility in the year of payment for feed that the payment must not result in a material distortion of income. The material-distortion-of-income standard is derived from section 446 of the 1954 Code. Subsection (a) of section 446 requires that taxable income be computed in accordance with the accounting method which the taxpayer regularly uses in calculating his income, and subsection (b) authorizes the Commissioner to vary any method of accounting which in his opinion "does not clearly reflect income."[5]

Treas. Reg. § 1.446-1(a)(2) (1957) elaborates that books consistently kept in accordance with accounting principles generally accepted in the trade, and consistently applied year to year, will ordinarily be regarded as "clearly reflecting income."[6]

[5] "(b) If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as in the opinion of the Secretary or his delegate, does clearly reflect income." I.R.C. § 446(b).

[6] "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year." Treas. Reg. § 1.446-1(a)(2) (1957).

The Government contends that the plaintiffs' deduction from 1968 income of their share of the partnership's payments for feed in December of that year fails clearly to reflect, and results in a material distortion of, income; and that section 446(b) accordingly authorizes a directed change in accounting method to allot the expense to 1969, where it would more accurately match expenses and income. The authority in section 446(b), says the Government, includes discretion to disallow specific deductions that distort income. While not directly contesting the Commissioner's basic authority, the plaintiffs respond that application of the material-distortion-of-income standard is inappropriate when the taxpayer-farmer uses the cash basis accounting system, explicitly allowed by regulation, namely, Treas. Reg. § 1.471-6(a)(1958).

The Government is no doubt correct in its position that the Commissioner has broad discretion to modify a taxpayer's accounting method to insure a clear reflection of income. See *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959); *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930). Even where the taxpayer's accounting method complies with generally accepted principles, the Commissioner may reject it if he determines that it does not clearly reflect the taxpayer's income. *American Automobile Assoc. v. United States*, 367 U.S. 687, 692, 695 (1961). And in challenging the Commissioner's determination, the taxpayer has a heavy burden of proof to show a clear abuse of discretion. *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 284 (1967). In *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970) the court found that an income of $129,899 computed by the taxpayer on the cash basis was not substantially the same result as the $127,804 of income under the accrual system directed by the Commissioner. The taxpayer, said the court, "must demonstrate substantial identity of results between his method and the method selected by the Commissioner." *Id.* at 356.

In seeking to exercise his discretion in this case, the Commissioner does not reject completely the taxpayer's choice of an accounting

method. Concerned only with the timing of a particular deduction, the Commissioner would change the year of deduction from the year in which the feed was bought to the following year. It is settled that the Commissioner has discretionary authority to disallow a particular deduction on the ground that the timing of the payment distorts income. *Burck v. Commissioner,* 533 F.2d 768, 773 (2d Cir. 1976); *Sandor v. Commissioner,* 62 T.C. 469, 476-77 (1974), *aff'd* 536 F.2d 874 (9th Cir. 1976).

Burck v. Commissioner involved a deduction of prepaid interest, a cost similar to the cost of feed bought in a year prior to its consumption. The Commissioner was held not to have abused his discretion in requiring a cash-basis taxpayer to use the accrual method to account for a prepaid interest deduction made on December 30. Noting "the ever-present potential for arbitrariness and evasiveness which is inherent in the cash-basis method of income tax accounting," the court held the Commissioner entitled to consider whether the prepayment of interest or of any other item resulted in a distortion of income. 533 F.2d at 769. The Commissioner might order a change in accounting for only one year or only one item out of several, as necessary to clearly reflect income, the overall accounting method to remain unchanged.

Additional authorities are *Commissioner v. Boylston Market Ass'n,* 131 F.2d 966 (1st Cir. 1942) and *Lovejoy v. Commissioner,* 18 B.T.A. 1179, 1182 (1930), cases in which cash-basis taxpayers were required to pro-rate, over the period involved, expenditures for insurance premiums and loan commissions. *Cf.* Treas. Reg. § 1.461-1(a)(1) (1957) (if expenditure by a cash-basis taxpayer "results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.").

There is thus no doubt as to the Commissioner's discretion to require a change in an overall accounting method which does not

clearly reflect income or, more specifically, to order a change in the treatment of a particular item where he finds that the accounting for it causes a material distortion of income. The next question is whether there is reason to hesitate to apply this rule in the case at bar.

Revenue Ruling 75-152, *supra,* lists some factors bearing on whether material distortion is present: "the customary business practice of the taxpayer in conducting his livestock operations, the amount of expenditures in relation to past purchases, the time of year in which the expenditure was made, and the materiality of the expenditure in relation to the taxpayer's income for that year." These factors serve as a guide in examining the facts of the instant case for material distortion of the taxpayer's income.

The partnership's deduction for feed taken in 1968 was $311,548, and no other transactions having taken place, this was the amount of loss reported in the partnership's information return. An expense of $311,548 is, in the absence of any income, of course material. In 1969, the partnership reported income of $141,596. Had the deduction been taken in 1969 instead of 1968, income for 1968 would have been zero instead of a loss of $311,548 and the 1969 return would have shown a loss of $169,952 instead of a profit of $141,596. The difference in result under the partnership's method of accounting as against that proposed by the Commissioner is plainly material.

The difference is equally significant in the returns of the partners, the taxpayer-plaintiffs. In 1968 their non-partnership income was $76,009. On taking their partnership loss of $33,959, they reported a gross income of $42,051 and a taxable income of $26,865. An expenditure or deduction of $33,959 is patently material in relation to an income of $76,400. In 1969 their gross income was less than $5,000 and their taxable income was zero. Had they taken the deduction for feed in 1969 instead of 1968, their taxable

income in 1968 would have been $60,824 instead of $26,865 and their 1969 income would have remained at zero. Again the choice of year for the deduction yields very different results.

It is apparent that taking the deduction in 1968 instead of 1969 brought about a material distortion of income, whether the income in question be that of the partnership or that of the taxpayers.

PART TWO

Despite his holding that there was a material distortion of income, Trial Judge Schwartz ruled that, since the taxpayers were farmers, using cash-basis accounting, they were entitled to the deduction in 1968. The core of his position was that farmers are expressly exempted by a long-standing regulation from having to use the inventory method of accounting if they do not wish to *(see* Treas. Reg. § 1.471-6(a) (1958)), that these taxpayers permissibly chose not to use the inventory method for their feed-supplies, and that the Commissioner's position would indirectly impose upon them the very inventory system which they allowably elected not to employ.

We come to the other conclusion because we view as decisive the undisputed finding here that, in the taxpayer's position, there would be a material distortion of income. Contrary to the trial judge, we see the Commissioner's refusal to allow deduction of the whole prepayment in 1968 — having found that to result in a distortion of income — not as imposing the inventory system, but rather as consistent with the cash system as the latter method is defined by the regulations and utilized for income tax purposes. Treas. Reg. § 1.461-1(a)(1) (1957) — expressly prescribing the general rule for the taxable year of deduction for all taxpayers using the cash receipts and disbursement method — declares that "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year,

such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made." Under that specific provision the feed-deduction must be taken, where there would otherwise be a material distortion of income, in the year or years that that kind of asset is consumed or utilized. Such treatment does not mean that an inventory system (applicable to "product costs")[7] is adopted *pro tanto* but only that "period costs" are recognized and melded into the over-all cash accounting method.[8] See Ward, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling* 75-152, 53 TEXAS L. REV. 1119, 1153-1155, 1156-1157, 1161 (1975). The regulation makes that kind of treatment of "period" costs (at least if income distortion would otherwise result) a part of the over-all cash method for all taxpayers, including farmers. *Cf. Burck v. Commissioner, supra,* 533 F.2d 768, 772-74 (2d Cir. 1976).

In this instance the feed bought late in December 1968 was not consumed until several months after the beginning of 1969 and some even lasted into 1970. Thus, the expenditures for grain in December 1968 created (in the words of the regulation) an asset "having a useful life which extend[ed] substantially beyond the close of the taxable year [1968]."[9] Added to that fact is the unchallenged finding of income distortion if the whole prepayment

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[7] "Product costs" are incurred in producing a product and are accounted for, under the inventory method, only on the sale of the products to which they relate. *See* Treas. Reg. § 1.471-1 (1958). In a cattle-growing business, for example, the cattle themselves could be included in inventory and accounted for on their sale or disposition. The Internal Revenue Service does not suggest that the feed be accounted for upon the sale of taxpayers' livestock.

[8] "Period costs" arise with respect to time intervals rather than with particular products or services. Examples are rent, insurance, interest and supplies consumed over a span of time.

[9] There is no question that this grain-feed asset was a separate and distinct asset for the plaintiffs.

was deducted in 1968.[10] Together, these elements justified the Internal Revenue Service in concluding that, even under the cash-basis method, the taxpayers could not deduct the whole feed-prepayment in 1968.[11] As we have said, there was no violation of Treas. Reg. § 1.471-6(a) (giving farmers the option not to use inventories) since inventories were not imposed on the taxpayers; the present feed-expenditures were permissibly considered as "period costs," to be deducted as the feed was consumed. What the Service did was to treat plaintiffs like other cash-method taxpayers — and, except with respect to inventories, there is no indication that in 1968 either Congress or the Regulations treated farmers who chose the cash-basis method differently from other such taxpayers. For all cash-method taxpayers, comparable "period costs" (where there would otherwise be income-distortion) would be spread over a time-span, as were these taxpayers' 1968 feed expenditures.

Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959), came to the opposite end-result, but that case differs from this one in at least three respects: (a) the *Cravens* court refused to find a distortion of income while here we have an unchallenged determination to that effect; (b) *Cravens* preceded Revenue Ruling 75-152, 1975-1 CUM. BULL. 144, and despite *Cravens* the Tenth Circuit itself held in *Cattle Feeders Tax Comm. v. Shultz,* 504 F.2d 462, 466 (10th Cir. 1974), that the predecessor of Rev. Rul. 75-152 could not be enjoined as plainly without any legal basis; and (c) the *Cravens* opinion did not consider the predecessor of Treas. Reg.

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[10] As explained *supra* in Part One of this opinion (under the heading "The Material-Distortion-of-Income Standard"), it is now settled (and accepted by both parties in this case) that the Internal Revenue Service has discretion to disallow a particular deduction on the ground that the timing of that payment distorts income. We do not believe that this rule, as applied here, conflicts with *Security Flour Mills Co. v. Commissioner,* 321 U.S. 281 (1944). *See* Ward, *supra,* 53 TEXAS L. REV. at 1159-1161.

[11] It is fair to note that the part of Treas. Reg. § 1.461-1(a)(1) on which we rely was apparently not pressed by the Government upon Trial Judge Schwartz, as it was upon us.

§ 1.461-1(a)(1), on which we rely. Similarly, the more recent decision in *Owens v. Commissioner,* 568 F.2d 1233, 1245-1246 (6th Cir. 1977), favorable to that farmer-taxpayer, refused to find income distortion, and likewise did not discuss Treas. Reg. § 1.461-1(a)(1) or the Revenue Ruling.[12]

CONCLUSION OF LAW

Upon the foregoing opinion, the court concludes as a matter of law that plaintiffs are not entitled to recover and the petition is dismissed.

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[12] Congress has recently dealt expressly with feed-expenditure deductions by "farming syndicates" (such as plaintiffs' entity appears to be). The Tax Reform Act of 1976, Pub. L. No. 94-455, § 207, 90 Stat. 1536 (1976) (to be codified in 26 U.S.C. § 464), restricts the deductions that may be taken by farming syndicates, including partnerships in which more than 35 percent of the losses are attributable to limited partners:

> "In the case of any farming syndicate * * * a deduction * * * for amounts paid for feed, seed, fertilizer, or other similar farm supplies shall only be allowed for the taxable year in which such feed, seed, fertilizer or other supplies are actually used or consumed, or, if later, for the taxable year for which allowable as a deduction * * *."

The Committee reports on this amendment cast no doubt on REV. RUL. 75-152 and do not suggest that Congress was changing the law. S. REP. NO. 94-938, 94th Cong., 2d Sess., 56 n.6 (1976) (1976-3 CUM. BULL. (Vol. 3) 49, 94 n.6); H.R.REP. NO. 94-658, 94th Cong., 1st Sess., 42 n.7 (1975) (1976-3 CUM. BULL. (Vol. 2) 695, 734 n.7).

APPENDIX B

In the

United States Court of Claims

TRIAL DIVISION
No. 131-75

(Filed: August 19, 1977)

ROBERT E. AND JANE ANN HARDEN CLEMENT

v.

THE UNITED STATES

Charles A. Pinney, Jr., attorney of record, for plaintiff.

James L. Malone III, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser* and *Robert S. Watkins*, of counsel.

OPINION*

SCHWARTZ, *Trial Judge:* The issue in this suit for an income tax refund is whether the taxpayers, limited partners in a cattle-feeding partnership, were under the law as it stood in 1968 entitled to deduct the cost of cattle feed bought in one year and consumed in the following year, as an ordinary and necessary business expense

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* The opinion and conclusion of law are submitted together with accompanying findings of fact in accordance with Rule 134(h). The necessary findings of fact are stated in the opinion.

in the year of purchase. The Commissioner disallowed the $33,959 sought to be deducted, the taxpayers paid the deficiency and claimed a refund of $14,170, and this suit followed the denial of the claim.

The Facts. The plaintiffs together constituted one of 10 limited partners in a California partnership known as Vanderbilt Group No. 2.[1] The partnership was organized under an agreement filed on December 1, 1968, to engage in the business of buyifig, feeding and selling cattle. The taxpayers contributed $35,000 to the partnership's initial capitalization of $321,000, entitling them to a 10.90342 percent share in the partnership profits and losses.

The partnership agreement provided that the single general partner should enter into a "Cattle Feeding Advisory and Services Agreement" with a Mr. R. C. Chapman, of Whittier, California, doing business as the Whittier Cattle Company. The agreement with Mr. Chapman, made in December 1968, vested him with management of the partnership's operations. He was authorized to propose cattle and feed investment programs, buy and sell both feed and cattle, locate feedyards for cattle and arrange the feeding, keep the partnership's accounts and manage its daily business.

Acting in his capacity as managing agent, Chapman on December 27, 1968 purchased $311,548 worth of cattle feed for the partnership in three lots:

1. 98,400 bushels of No. 2 yellow corn at $1.23 per bushel, a total of $121,032, bought from Cargill, Inc., Omaha, Nebraska, to be delivered to the Cargill warehouse at Omaha, Nebraska;

[1] The parties have stipulated that both plaintiffs, Robert E. and Jane Ann Harden Clement, husband and wife, were limited partners in the partnership. The record indicates that only Mrs. Clement invested and participated in the partnership. Her profits and losses, however, were reflected in the joint tax return jointly filed by both husband and wife.

2. 2,563 tons of milo at $1.82 per hundredweight or $36.40 per ton, a total of $93,298, bought from Western Beef Grain Co., Amarillo, Texas, to be delivered to the Alamo Feed Yard, Calpatria, California; and
3. 1,980 tons of milo at $49.10 per ton, a total of $97,218, bought from Cargill, at Omaha, Nebraska, to be delivered in California berween January and March 1969.

The purchase price was paid and the check cleared before the end of the year. The grain purchased was in existence; the partnership obtained warehouse receipts for the entire amount. The purchase of grain was the partnership's only business transaction in 1968.

The partnership filed an information return for 1968, reporting a gross profit of zero, a deduction of $311,548 on account of the purchase of grain and thus a net loss of $311,548. The plaintiffs' 10.9 percent share of the loss was $33,959, the only loss in the adjusted gross income they reported in their cash basis joint return for 1968. The loss reduced their otherwise gross income from $76,009 to $42,051. The return showed the following gains and partnership loss:

Dividends	$17,587
Interest	4,993
Rental property income	5,902
Trust Income	17,820
Operation of hobby shop	3,959
Sale/exchange of property	23,948
Miscellaneous (trustee fee)	1,800
Vanderbilt No. 2 loss	(33,959)
Adjusted Gross Income	$42,051

The adjusted gross income of $42,051 was reduced by deductions and exemptions to a taxable income of $26,865. As already noted, the Commissioner's disallowance of the loss of $33,959 is the basis of the present suit.

Chapman began to purchase cattle shortly after the beginning of the new year. It took about 2 weeks after the transaction for the cattle purchased to be delivered to the feedlot. While the dates of purchase are not clear on the record, cattle began arriving at the designated feedlots on or about January 15, 1969. The 4,268 head of cattle bought by the partnership arrived in 17 lots at the following dates between January and July 1969:

January 15, 1969	573 head
January 17, 1969	124
January 23, 1969	92
March 24, 1969	100
March 28, 1969	121
April 21, 1969	146
April 22, 1969	116
April 24, 1969	248
May 23, 1969	352
May 26, 1969	372
May 28, 1969	279
June 2, 1969	244
June 5, 1969	187
June 20, 1969	1,113
July 10, 1969	170
July 14, 1969	10
July 28, 1969	21
	4,268 head

In the spring, Chapman exchanged the warehouse receipts for 44,000 of the 98,400 bushels of the partnership's corn in Omaha, for the same amount delivered to an Oakland, Iowa feedyard, on payment of a transportation differential. Thereafter, he sold back to his vendor, Cargill, the receipts for the remaining 54,400 bushels at Omaha for $1.2475 per bushel, less a storage charge of .0036 cents per bushel, and bought 55,000 bushels at Grand Island, Nebraska, for $1.22 per bushel.

The cattle owned by the partnership eventually consumed an amount of feed roughly equal to the amounts first purchased in

the prior December, plus additional feed bought in 1969 at a cost of $59,429. Some small amounts of milo and corn were apparently left over and sold to feedyards, and the proceeds were reported as income. The partnership's gross profit on the sale of the feed cattle in 1969 was $271,936. Its information return in that year showed a gross profit in that amount, expenses of $130,340 and a net profit of $141,596, of which the plaintiffs' 10.9 percent share was $15,439.

Despite a profit from Vanderbilt No. 2 of $15,439, the taxpayer-plaintiffs' adjusted gross income was reduced by substantial losses from other investments to $4,423, as follows:

Dividends	$ 9,937
Interest	3,018
Rental property income	3,976
Trust income	19,670
Trustee fee	1,800
Operation of hobby shop	817
Sale/exchange of property	15,880
An unrelated business loss	(17,779)
Oil well investment expenses	(48,333)
Vanderbilt No. 2 income	15,439
Adjusted Gross Income	$ 4,423

Deductions and exemptions reduced taxable income to zero, actually a loss.

In 1970 the partnership in its information return reported a gross profit of $104,379 from the sale of cattle and feed, expenses of $46,424, including $29,875 for grain, and a net profit of $57,955, of which profit the plaintiffs' share was $6,345.

In 1970 the plaintiffs' adjusted gross income was $10,338, reflecting the profit of $6,345 from Vanderbilt No. 2 and further substantial losses in an oil well venture, as follows:

Dividends	$ 2,614
Interest	3,206

Rental property income	4,517
Trust income	19,810
Trustee fee	1,800
Operation of hobby shop	1,917
Sale/exchange of property	(1,000)
Partnership income (other than Vanderbilt No. 2)	615
Loss from oil well investment	(29,485)
Vanderbilt No. 2 income	6,345
Adjusted Gross Income	$10,338

Deductions and exemptions again, as in 1969, reduced the taxable income to zero, actually a deficit of $518.

The Issues. The issues requiring decision involve the application to the facts of the instant case of three tests for deductibility stated in Revenue Ruling 75-152, 1975-1 C.B. 144. In that Ruling, the Commissioner takes the firm position that a farmer who keeps his books under the cash receipts and disbursements accounting system may deduct, in the year of payment, the cost of feed which will be consumed in the following year, only if the three conditions are met:

> ... (1) the expenditure is for the purchase of feed rather than a deposit, (2) the prepayment is made for a business purpose and not for tax avoidance, and (3) the deduction will not result in a material distortion of income.

Furthermore, the first two conditions must be fully satisfied before consideration of the deduction's effect on income is proper. The first condition — that the expenditure be a purchase and not a deposit — is met on the facts, and is not in issue. The second and third conditions raise contested issues: whether the expenditure was made for a business purpose and whether the deduction materially distorted income.

The Business Purpose of the Purchase. The Government contends that the partnership's 1968 expenditures had none of the characteristics of a business purpose. In response, plaintiffs urge that

a business purpose is not a prerequisite to deductibility where the prepayment is made pursuant to a binding contract and is not merely a deposit. Moreover, plaintiffs maintain that if a business purpose is required, it was present, because the costs of the advance purchases of feed were "ordinary and necessary expenses" of the partnership's cattle feeding business and deductible under the provisions of I.R.C. § 162(a).

A classic formulation of what is a deductible "necessary" business expense under I.R.C. § 162(a) is an expenditure that is "appropriate and helpful" in the accomplishment of the taxpayer's trade or business, while a deductible "ordinary" business expense is identified by reference to expenditures of the business community to which the taxpayer belongs. *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933). Actual outlays for feed are ordinary and necessary, for they are entirely appropriate and helpful in the carrying on of the business of feeding cattle. Treas. Reg. § 1.162-12 (1972).

The Government's contention as to business purpose goes, however, not to the thing bought, but to the timing of its purchase. The primary purpose of the decision to buy feed in December 1968, rather than in 1969 when it would be needed, the Government says, was not business benefit but tax avoidance. Business purpose would be conceded for a purchase in December of enough feed solely for the cattle soon to be delivered. Business purpose is contested for the purchase in December of feed for cattle bought in the following March and thereafter.

Plaintiffs assert that if a payment for cattle feed is more than a deposit — that is, if it is an actual purchase — its timing need not have a business purpose. Reliance is put on *Mann v. Commissioner*, 483 F.2d 673, 680 (8th Cir. 1973) in which an outlay in advance of need, made pursuant to a binding contract, was held deductible. There the court wrote that it found no "substantial support in the cases" for the Government's contention "that a benefit to the taxpayer is necessary to support the timing of a bus-

iness expense deduction which meets the terms of § 162(a) in a situation where . . . payment is made pursuant to a binding contract." 483 F.2d at 680. The court went on, nevertheless, to find a business purpose; the purchase was held to benefit the taxpayer because it fixed a maximum price for feed, obtained for him a preferred position in case of a shortage, and assured known feed costs before the scope of the operation was determined. Accordingly, the court commented that the "issue need not be decided to resolve this case in light of our determination that a benefit to the taxpayer has been established." 483 F.2d at 680.

Other cases cited for the dispensability of a business purpose also found a business purpose in fact. In *Gaddis v. United States*, 330 F. Supp. 741, 750 (S.D. Miss. 1971) the prepayment was intended to forestall the impact of a possible rise in prices and feed shortage. In *Cravens v. Commissioner*, 272 F.2d 895, 897 (10th Cir. 1959) drought prompted the taxpayer to act to avert a feed shortage. Only in *Ernst v. Commissioner*, 32 T.C. 181, 185-86 (1959) did the court fail to find a business purpose, but there the issue was framed solely in terms of whether the prepayment was a deposit, and the court held the feed purchase expense incidental to carrying on a trade or business under section 162(a). There is, therefore, little authority for the proposition that an actual outlay for feed, not a deposit, may be deductible though made a year before it is needed, without regard to its lack of a business purpose. Acceptance of the proposition would confront the policy that tax consequences should be based on business reality and not on mere events created to avoid taxes. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Waterman S.S. Co. v. Commissioner*, 430 F.2d 1185, 1193 (5th Cir. 1970), *cert. denied* 401 U.S. 939 (1971); *see* also *Welch v. Helvering*, 290 U.S. 111 (1933). As in *Mann v. Commissioner*, *supra*, however, the present case does not require a decision on the proposition, for as will be seen, there is evidence here of business purpose.

A number of factors may demonstrate a taxpayer's legitimate business purpose in prepaying for feed not consumed until the next tax year. Fixing a maximum price, obtaining a guaranteed supply to avoid the effects of a feed shortage, and obtaining advantages in the negotiation of storage and delivery terms are some of such factors. *See Mann v. Commissioner*, *supra*, 483 F.2d at 679-80; *Cravens v. Commissioner*, *supra*, 272 F.2d at 899-900; *Gaddis v. United States*, *supra*, 330 F. Supp. at 750; Rev. Rul. 75-152, *supra*, 1975-1 C.B. at 144. If the taxpayer has a reasonable expectation of a business benefit when he purchases feed in the year prior to consumption, then the prepayment has served a legitimate business purpose. Rev. Rul. 75-152, *supra*.

The Government asserts that Vanderbilt No. 2 was not motivated by any reasonable expectation of a business benefit when it purchased grain in December 1968; that the partnership acted in haste and without a business plan for feeding operations, in order to create a deduction in 1968; and that the changes in the feeding plan in 1969 — the 1969 resales and movement of the corn bought in 1968 — indicate the actual lack of a feeding plan in 1968 and refute the plaintiffs' claim of legitimate business motivation in 1968.

The plaintiffs' response is essentially Mr. Chapman's testimony on trial that all his operations in 1968 and 1969 were according to an original plan, or amendment consistent with his original plan, to obtain an economic benefit. Chapman, who is an agricultural economist and has had considerable experience in the cattle business, testified as follows: In December 1968, he decided on the number of cattle he would feed and upon the general locations at which he would feed them — California and Oakland, Iowa, the closest feedyard to Omaha. He chose the Omaha area because it was one of the lowest priced feed markets and was expanding its packing plant capacity, thus assuring a demand for cattle. By

thus increasing the partnership's business in a growing area, Chapman expected to avoid complete dependence on California markets.

Mr. Chapman explained his exchanges of Omaha corn for corn delivered at Oakland, Iowa, and his sale of Omaha corn and purchase of the same amount in Grand Island, Nebraska. Though he would purchase grain in Omaha, the location with the largest storage capacity and lowest prices, his first intention was to feed the partnership's midwest cattle in the feedyard closest to Omaha, which was in Oakland, Iowa. That yard, however, had only a limited capacity to store grain. He was aware, at the time he purchased the grain in Omaha in December, that he would have to pay a transportation differential to transfer the grain from Omaha to the feedyard in Oakland, as he did in fact in April 1969. The subsequent transfer of part of his feeding operation from Oakland to Grand Island, Nebraska, was in accordance with his practice in managing cattle feeding ventures, which was to shift yards when better terms were offered. He made the change, he said, in response to a better economic arrangement at the Harrington Feed Yard in Grand Island.

Chapman testified to economic justifications for the purchases in December. He explained that his studies had shown that in 8 of 10 years, grain was cheapest in the fall. Because prices tended to rise significantly in the spring, he wanted to fix his costs in December. Purchases in December also assured a sufficient supply of grain to feed the number of cattle that he planned to buy.

Continuing, he testified that the premium paid to obtain warehouse receipts (which normally sell at a premium of 1 to 5 cents because of their value as a warranty of the nature of the grain) was a hedge against the possibility of unexpected shortages. Having decided that feeding would take place in California and eastern Nebraska/western Iowa, his purchases in December served to assure that the grain would be in his planned general location when

actual feeding began. By committing the partnership in 1968, he was also able to negotiate favorable storage rates, eliminating such charges entirely in some instances and incurring only partial charges in others.

A second witness for plaintiff, Mr. Leon Miller, also testified to the reasonableness of the partnership's 1968 purchasing decision. Mr. Miller is a California cattle marketer and grain trader with experience in the cattle feeding business. He testified that it is a common practice in the Southern California cattle industry to purchase feed in the year prior to consumption, to ascertain the total cost of feeding the cattle, to protect against increased costs, and to help in obtaining favorable storage rates.

The Government's response to Messrs. Chapman and Miller is based entirely upon the testimony of its expert witness, Mr. Jack Ross, a feed grain analyst for the Economic Research Service of the United States Department of Agriculture. Citing forecasts of the Department which he had helped to prepare in the fall of 1968, Mr. Ross described the grain market at that time as one of ample supply and moderately rising demand with generally stable prices, except for an anticipated normal seasonal price rise of about 15 cents a bushel. Corn, he said, is the most significant factor in the grain market, because it is the dominant feed grain produced. The Department of Agriculture forecast a supply of 5.6 billion bushels of corn with total demand expected to equal 4.5 billion bushels. The market was very stable, he testified, with the Government controlling sufficient reserves to prevent any distortions. He concluded that in the market then existing, it was unnecessary and unreasonable for the partnership to purchase such large amounts of feed in December 1968, prior to the acquisition of its cattle in the spring of 1969.

The December purchases are held, on a weighing of the testimony of the opposing witnesses, to have had a business purpose.

Mr. Chapman did assure himself of a supply. He did fix prices, thereby learning the scope of his costs for feed. His explanation of his movements of corn and feedlots in 1969 is credible and rebuts the Government's claim that his 1969 dealings in feed show haste and lack of planning in the purchases in December 1968, and nullify the price advantages Mr. Chapman obtained by purchasing before the seasonal advances in price. The Government has also argued that if the Grand Island price of $1.22 did not include the customary premium of 1 to 5 cents for warehouse receipts instead of actual feed, then the May price was higher than the December Omaha price, which had included a premium for the guarantee represented by the warehouse receipts acquired. This is a small and speculative point. In fact, Chapman paid $1.23 per bushel to Cargill in Omaha in December, sold receipts for 54,400 bushels back to Cargill in the spring for $1.2475, less .0036 cents for storage, or a net cost of $1.2439, and bought 55,000 bushels in Grand Island for $1.22 per bushel, a total net profit of 0.239 per bushel, or a total net profit of $1,300.16 on the 54,400 bushels first bought (.0239 x 54,400). The exchange of 44,000 bushels of Omaha corn for Oakland corn in April 1969 cost Chapman a transportation differential of .06 cents per bushel or a total of $2,640. But, he testified, it was part of his original plan to buy in Omaha and feed in Oakland. Chapman said that he expected in December that his prices then would be the maximum he would pay, and he seems to have been right.

There is not enough to the Government's case to overcome the convincing testimony of Mr. Chapman of the business reasons for his decision to buy in December, supported by the testimony of the additional witness that Chapman was following the common practice of breeders and cattle feeders in Southern California. The Government's evidence as to the Department of Agriculture forecasts may be accepted in full and yet it was Chapman's privilege to plan and buy as he did, for the reasons he gave. The businessman is allowed discretion to make business judgments. The Government's expert is neither a cattle breeder nor feeder nor grain buyer.

He did not testify as to trade practice in Southern California or elsewhere, or trade reliance on his forecasts. Neither his forecasts nor hindsight in recounting the failure of prices to rise or shortages to develop negative the partnership's motive in its opening days to assure a supply of feed at a known price and thereby to fix the costs for feed before undertaking the required major outlays for cattle. The totality of the evidence establishes a business purpose under the authorities already cited, and this condition for deductibility is met.

The Material-Distortion-of-Income Standard. Revenue Ruling 75-152, *supra,* imposes, as well as the business purpose test, the condition upon deductibility in the year of payment for feed that the payment must not result in a material distortion of income. The material-distortion-of-income standard is derived from section 446 of the 1954 Code. Subsection (a) of section 446 requires that taxable income be computed in accordance with the accounting method which the taxpayer regularly uses in calculating his income, and subsection (b) authorizes the Commissioner to vary any method of accounting which in his opinion "does not clearly reflect income."[2]

Treas. Reg. § 1.446-1(a)(2) (1957) elaborates that books consistently kept in accordance with accounting principles generally accepted in the trade, and consistently applied year to year, will ordinarily be regarded as "clearly reflecting income."[3]

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[2] "(b) If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as in the opinion of the Secretary or his delegate, does clearly reflect income * * *." I.R.C. § 446(b).

[3] "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year." Treas. Reg. § 1.446-1(a)(2).

The Government contends that the plaintiffs' deduction from 1968 income of their share of the partnership's payments for feed in December of that year fails clearly to reflect, and results in a material distortion of, income; and that section 446(b) accordingly authorizes a directed change in accounting method to allot the expense to 1969, where it would more accurately match expenses and income. The authority in section 446(b), says the Government, includes discretion to disallow specific deductions that distort income. While not directly contesting the Commissioner's basic authority, the plaintiffs respond that application of the material-distortion-of-income standard is inappropriate when the taxpayer-farmer uses the cash basis accounting system, explicitly allowed by regulation, namely, Treas. Reg. § 1.471-6(a)(1958).

The Government is no doubt correct in its position that the Commissioner has broad discretion to modify a taxpayer's accounting method to insure a clear reflection of income. *See Commissioner v. Hansen,* 360 U.S. 446, 467 (1959); *Lucas v. American Code Co.,* 280 U.S. 445, 449 (1930). Even where the taxpayer's accounting method complies with generally accepted principles, the Commissioner may reject it if he determines that it does not clearly reflect the taxpayer's income. *American Automobile Assoc. v. United States,* 367 U.S. 687, 692, 695 (1961). And in challenging the Commissioner's determination, the taxpayer has a heavy burden of proof to show a clear abuse of discretion. *Fort Howard Paper Co. v. Commissioner,* 49 T.C. 275, 284 (1967). In *Wilkinson-Beane, Inc. v. Commissioner,* 420 F.2d 352 (1st Cir. 1970) the court found that an income of $129,899 computed by the taxpayer on the cash basis was not substantially the same result as the $127,804 of income under the accrual system directed by the Commissioner. The taxpayer, said the court, "must demonstrate substantial identity of results between his method and the method selected by the Commissioner." 420 F.2d at 356.

In seeking to exercise his discretion in this case, the Commissioner does not reject completely the taxpayer's choice of an accounting method. Concerned only with the timing of a particular deduction, the Commissioner would change the year of deduction from the year in which the feed was bought to the following year. It is settled that the Commissioner has discretionary authority to disallow a particular deduction on the ground that the timing of the payment distorts income. *Burck v. Commissioner,* 533 F.2d 768, 773 (2d Cir. 1976); *Sandor v. Commissioner,* 62 T.C. 469, 476-77 (1974), *aff'd* 536 F.2d 874-75 (9th Cir. 1976).

Burck v. Commissioner involved a deduction of prepaid interest, a cost similar to the cost of feed bought in a year prior to its consumption. The Commissioner was held not to have abused his discretion in requiring a cash-basis taxpayer to use the accrual method to account for a prepaid interest deduction made on December 30. Noting "the ever-present potential for arbitrariness and evasiveness which is inherent in the cash-basis method of income tax accounting," the court held the Commissioner entitled to consider whether the prepayment of interest or of any other item resulted in a distortion of income. 533 F.2d at 769. The Commissioner might order a change in accounting for only one year or only one item out of several, as necessary to clearly reflect income, the overall accounting method to remain unchanged.

Additional authorities are *Commissioner v. Boylston Market Ass'n,* 131 F.2d 966 (1st Cir. 1942) and *Lovejoy v. Commissioner,* 18 B.T.A. 1179, 1182 (1930), cases in which cash-basis taxpayers were required to pro-rate, over the period involved, expenditures for insurance premiums and loan commissions. *Compare* Treas. Reg. § 1.461-1(a)(1) (1957), which provides that an expenditure by a cash-basis taxpayer "which results in the creation of an asset having a useful life extending substantially beyond the close of the taxable year, may not be deductible, or may be deductible only in part in the taxable year in which payment is made."

There is thus no doubt as to the Commissioner's discretion to require a change in an overall accounting method which does not

clearly reflect income or, more specifically, to order a change in the treatment of a particular item where he finds that the accounting for it causes a material distortion of income. The next question is whether there is reason to hesitate to apply this rule in the case at bar.

Revenue Ruling 75-152, *supra,* lists some factors bearing on whether material distortion is present: "the customary business practice of the taxpayer in conducting his livestock operations, the amount of expenditures in relation to past purchases, the time of year in which the expenditure was made, and the materiality of the expenditure in relation to the taxpayer's income for that year." These factors serve as a guide in examining the facts of the instant case for material distortion of the taxpayer's income.

The partnership's deduction for feed taken in 1968 was $311,548, and no other transactions having taken place, this was the amount of loss reported in the partnership's information return. An expense of $311,548 is in the absence of any income of course material. In 1969, the partnership reported income of $141,596. Had the deduction been taken in 1969 instead of 1968, income for 1968 would have been zero instead of a loss of $311,548 and the 1969 return would have shown a loss of $169,952 instead of a profit of $141,596. The difference in result under the partnership's method of accounting as against that proposed by the Commissioner is plainly material.

The difference is equally significant in the returns of the partners, the taxpayer-plaintiffs. In 1968 their non-partnership income was $76,009. On taking their partnership loss of $33,959, they reported a gross income of $42,051 and a taxable income of $26,865. An expenditure or deduction of $33,959 is patently material in relation to an income of $76,400. In 1969 their gross income was less than $5,000 and their taxable income was zero. Had they taken the deduction for feed in 1969 instead of 1968, their taxable

income in 1968 would have been $60,824 instead of $26,865 and their 1969 income would have remained at zero. Again the choice of year for the deduction yields very different results.

It is apparent that taking the deduction in 1968 instead of 1969 brought about a material distortion of income, whether the income in question be that of the partnership or that of the taxpayers. Because, however, the taxpayers were farmers, using cash-basis accounting, the material-distortion-of-income standard is said not to apply.

Discussion of farmers' privileges in accounting begins with the general business practice of matching income with related expenses as a means of avoiding distortions in income. Standard practice in such matching is inventory accounting. By adding to inventory at the beginning of a year any purchases made, and then subtracting closing inventory, the accountant taxpayer can determine the cost of goods sold during the year. This cost is then deducted from gross receipts to arrive at gross income. Inventory accounting requires that materials be accounted for as they are used, thus assigning to each accounting period its appropriate costs, and, thereby, its profits and losses. See W. Paton and A. Littleton, *An Introduction to Corporate Accounting Standards* (1964) 15; 2 *Mertens Law of Federal Income Taxation* (1974) § 16.

The Internal Revenue Code recognizes the valuable role of inventory accounting in obtaining an accurate computation of income. Section 471 specifically authorizes regulations requiring that a taxpayer use inventories whenever necessary to determine income. Accordingly, Treas. Reg. § 1.471-1 (1958) directs the use of inventories "in every case in which the production, purchase, or sale of merchandise is an income-producing factor."[4] When an

[4] "In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor • • •." Treas. Reg. § 1.471-1.

inventory is used, the accrual method of accounting is necessary to clearly reflect income. Treas. Reg. § 1.446-1(c)(2)(i)(1957).[5]

Farmers raising livestock as producers of goods and services would seem from the foregoing to be required to use inventories. But Treas. Reg. § 1.471-6(a) (1958) exempts farmers from mandatory use of the inventory method of accounting and permits them optional use of the cash receipts and disbursements method of accounting.[6] The objective of the farmers' exemption is simplicity. The practical complexities of inventory accounting are regarded as too burdensome to impose upon most farming operations. "The sacrifice in accounting accuracy under the cash method represents an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting system." *United States v. Catto*, 384 U.S. 102, 116 (1968).

Section 446(b) of the Code, *supra*, requires as a first principle the use of an accounting method which clearly reflects income. It does not, however, override the force for farmers of their exemption pursuant to section 471 from the use of inventory accounting, a use which might otherwise have been required for the clear reflection of their income. There is no derogation from the clear-reflection-of-income standard of section 446(b), for section 471 is a specific application of the requirement of section 446 that when authorized by the Commissioner inventory accounting be used as necessary clearly to reflect income. The regulations under Code section 471 in section 1.471-1 impose a general requirement of inventory accounting and in section 1.471-6(a) exempt the farmer from the use of inventory accounting as an exception to the general rule of the regulations in section 1.471-1. Section 471 of the Code is an explicit grant to the Commissioner of authority to prescribe inventories as a method of carrying out the principle of clear-reflection-of-income in section 446. The section has been in force since 1915 and is recognized as having vested in the Commissioner authority of wide scope to make legislative rules. *Space Controls, Inc. v. Commissioner*, 322 F.2d 144 (5th Cir. 1963); J. Chommie, *Law of Federal Income Taxation* 255 (2d ed. 1933); L. Ward, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152*, 53 Tex. L. Rev. 1119, 1147-48 (1975). It is too late to limit the plain exemptions given the farmer. The Commissioner may thus not directly require the taxpayer-farmer to use inventories. The plaintiffs argue that the Commissioner would do indirectly what he cannot do directly — that an application of the material-distortion-of-income standard to the cash-basis prepayment of feed would in effect impose upon farmers the use of inventory accounting for feed expenditures, thus denying them the option given by Treas. Reg. § 1.471-6(a). Instead of simply deducting the feed cost at the time of purchase, under the Commissioner's view the farmer would be required to defer the deduction and amortize the cost of the feed over the period in which the feed was used.

The criticism of the Commissioner's contentions has merit. There are difficulties, practical and legal, in requiring a taxpayer to inventory feed to meet the material-distortion-of-income standard. Recognizing these difficulties, the court in *Gaddis v. United States, supra*, agreed with the accountant who testified for plaintiff "that if the plaintiff were required to charge expense of chicken feed as it were delivered or as the chickens consumed it, rather than as it was paid for, this would amount to a 'real burdensome type of operation' and that it would not be possible to trace this feed through a perpetual inventory from the time it was purchased until

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[5] "(2) *Special rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph." Treas. Reg. § 1.446-1(c).

[6] "A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used * * *." Treas. Reg. § 1.471-6.

it was delivered to the Breeder Farm and would be inconsistent with the cash method of accounting." 330 F. Supp. at 758. The accounting difficulties are real and farmers are saved from them by the regulation which explicitly allows the use of cash-basis accounting. The Commissioner may not use the material-distortion-standard so as to withdraw the privilege given by the regulation. Inventory accounting may not in fact be a burden to sophisticated farming syndicates such as the plaintiffs' limited partnership. But section 1.471-6 of the Regulations gives the exemption from inventory-keeping to the plaintiffs equally with other farmers. The privilege given to all farmers to avoid the complexities of inventory accounting cannot be denied these plaintiff-farmers, because of their sophistication.

Another criticism which can be levelled at the Government's application of the material-distortion-of-income-standard to require the feed deduction be taken in 1969 rather than 1968 is that it would enforce an ad hoc accounting for a single item and thus impose a transactional and hybrid method of accounting of the kind strongly disapproved by the court in *Security Flour Co. v. Commissioner,* 321 U.S. 281 (1944). The taxpayer there had collected a processing tax as part of the price of goods sold to its customers during one year. On paying into court $93,000 in tax proceeds the taxpayer challenged the constitutionality of the tax. The tax was invalidated, the money was returned to the taxpayer, and the taxpayer made refunds to its customers over the next 3 years. The taxpayer was on the accrual basis, but in order clearly to reflect its income it sought to deduct the payments from its income in the year of the original tax collection. The court agreed with the Commissioner in rejecting the effort and expressed its disapproval of a case-by-case, transactional exception to the general rules of accounting by annual periods. Such hybrid systems were characterized as "divided and inconsistent methods of accounting not properly to be denominated either a cash or accrual system." 321 U.S. 287. The clause "to clearly reflect income" in the revenue

act of the time, now I.R.C. § 446(b), the court said, was intended "to take care of fixed liabilities payable in fixed installments over a series of years" and not to take cash items or accrued obligations out of the annual accounting system in order to work a "supposedly more equitable result for the Government or to the taxpayer." 321 U.S. at 285-86. In *United States v. Catto, supra,* 384 U.S. at 116-17, the court again rejected what it described as hybrid accounting, in denying a taxpayer the right to use the cash method for part of its ranching operation while otherwise retaining the accrual method for its overall operation.

Nevertheless, the Commissioner has discretion to review accounting methods and to disallow specific deductions to insure a clear reflection of income, as has been reiterated elsewhere. *See Commissioner v. Hansen, supra,* 360 U.S. at 467; *Burck v. Commissioner, supra,* 533 F.2d at 772-73. This discretion is held, however, to stop short of the farmer's cash-basis system. Thus, in *Cravens v. Commissioner, supra,* 272 F.2d at 900-01 the court rejected a Government contention that under the predecessor of the present section 446, the Commissioner could disallow a prepaid feed deduction on the ground that it caused a material distortion of income:

> In the case of farmers and cattle raisers, the use of a transactional basis for the computation of income would bring confusion into the federal tax system. The treatment of the cost of seed, fertilizer, and feed purchased one year for use in the next year is simple if the deduction is allowed when paid if cash basis applies or when incurred if accrual basis is used. If each transaction must be analyzed to determine whether a distortion of income will result from the allowance of a business expense deduction, § 43 is, in our opinion, given a meaning which Congress did not intend.

The court in *Gaddis v. United States, supra,* 330 F. Supp. at 757-58, similarly refused to apply a transactional approach to farmer's feed purchases, relying on *Security Flour Mills Co.* and

Cravens. Nevertheless, the Commissioner seeks in the instant case to apply the disapproved transactional approach.

There are doubtless in this case distortions from the use of the cash receipts and disbursements accounting system which in the case of a non-farmer would not clearly reflect his income. This taxpayer is however a farmer and the distortions result from its use of cash-basis accounting, an option explicitly available to farmers by longstanding regulation. Treas. Reg. § 1.471-6, *supra; see also United States v. Catto, supra.* The farmers' option to use the cash basis is now too long and lawfully established to be withdrawn by the courts.[7]

In conclusion, the distortion in income by the farmer's cash-basis accounting for the deduction of the cost of cattle feed in the year before it is consumed is tolerated because the taxpayer is a farmer, in the interest of avoiding infringement upon the farmer's special prerogative to use cash-basis accounting, under Treas. Reg. § 1.471-6(a), and also because to do otherwise would require the farmer-taxpayer to engage in disapproved ad hoc and hybrid accounting instead of his regular and consistent method. The issues having been decided for the plaintiffs, they are entitled to judgment for a refund with interest as provided by law, the amount to be determined by agreement and if agreement is not reached, in further proceedings under rule 131(c).

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[7] Congress has recently limited the option in the case of "farming syndicates." I.R.C. § 464, as amended by § 207 of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1536, 26 U.S.C. § 464, restricts the deductions that may be taken by farming syndicates, including partnerships in which more than 35 percent of the losses are attributable to limited partners:

> "In the case of any farming syndicate • • • a deduction • • • for amounts paid for feed, seed, fertilizer, or other similar farm supplies shall only be allowed for the taxable year in which such feed, seed, fertilizer or other supplies are actually used or consumed, or, if later, for the taxable year for which allowable as a deduction • • •."

FINDINGS OF FACT

The Plaintiffs and their Suit

1. Vanderbilt Group No. 2 is a bona fide partnership lawfully organized under the laws of California to engage in the business of buying, feeding and selling cattle.

2. Following discussions at some time between August and December 1968, Vanderbilt Group No. 2 was organized in December of 1968. The partnership was comprised of one general partner and 10 limited partners.

3. Plaintiffs Robert E. and Jane Ann Harden Clement are stipulated to have been bona fide limited partners of Vanderbilt No. 2. They contributed $35,000 to the partnership's initial capitalization of $321,000. They were to share in the profits and losses of the partnership in a proportion of 10.90 percent.

4. The partnership expended a total of $311,548 for grain purchases in 1968. This amount was reported on the partnership's information return as a farming expense (cattle feed), and as the partnership's net loss for the year. On their joint federal income tax return for 1968, the plaintiffs deducted from gross income $33,958.72 as their share of this partnership loss, resulting in a substantial reduction in their income tax liability reported on the return.

5. The partnership and the plaintiffs reported income and expense for tax purposes on the cash method of accounting and on a calendar year period.

6. The deduction of $33,958.72 taken by plaintiffs on their income tax return was disallowed by the Internal Revenue Service on July 3, 1973. On March 15, 1974, plaintiffs paid the $14,170.35 deficiency in income tax and assessed interest resulting from the Service's disallowance of the claimed deduction.

Thereafter, on May 29, 1974, plaintiffs filed a timely claim for refund and on the denial of the claim this suit followed.

The Partnership Operations in 1968 and 1969

7. Mr. Lee Rensberger was Vanderbilt No. 2's only general partner. As general partner, Mr. Rensberger had exclusive control of the business of the partnership, including the power to assign duties, to sign all contracts, and to assume direction of business operations. The partnership agreement provided that the general partner's primary responsibility was to enter into, and operate under, a Cattle Feeding Advisory and Services Agreement with Mr. Richard C. Chapman of Whittier, California, doing business as Whittier Cattle Company.

8. In December 1968, the partnership entered into a Cattle Feeding Advisory and Services Agreement with Mr. Chapman. Under the terms of that agreement, Chapman managed the partnership's cattle business on a daily basis under the supervision of the general partner. Chapman's duties for the partnership included:

(1) proposing a cattle investment program
(2) purchasing feed ingredients and cattle
(3) identifying and arranging for feedyards in which to place the cattle
(4) assuring delivery of feed
(5) inspecting cattle while on feed
(6) keeping partnership accounts
(7) selling the cattle, collecting purchase price and closing the books.

9. Mr. Chapman has been an agricultural economist since 1939, with some experience as a paid consultant to the Secretary of Agriculture in the 1950's. He has owned and operated cattle feeding businesses since 1964.

10. The partnership's purchase of $311,548 worth of cattle feed ingredients in 1968 was accomplished by its agent Chapman, and took place on December 27, 1968, as follows:

(a) 98,400 bushels of No. 2 yellow corn were purchased from Cargill, Inc., Omaha, Nebraska, at a price of $1.23 per bushel for a total cost of $121,032;

(b) 2,563.13 tons of milo were purchased from the Western Beef Grain Company, Amarillo, Texas, at a price of $1.82 per hundred weight or $36.40 per ton for a total cost of $93,297.93. The milo was to be delivered to Alamo Feed Yard, Calpatria, California; and

(c) 1,980 tons of milo were purchased from Cargill, Inc., Omaha, Nebraska, at a price of $49.10 per ton for a total price of $97,218. The milo was to be delivered to California between January and March of 1969.

11. The feed so purchased was specific and in existence.

12. The partnership obtained warehouse receipts for all of the feed so purchased.

13. There were no provisions for refunds of amounts paid by the partnership for the feed.

14. The $311,548 purchase price was paid and cleared through the partnership's bank account prior to December 31, 1968.

15. It is a standard practice in the cattle feeding industry to buy in advance and have on hand grain sufficient to feed the cattle to be purchased. If necessary, grain can be purchased on 24 hours' notice.

16. The partnership, through Mr. Chapman, was negotiating, prior to December 31, 1968, for feedyards in which to place its cattle.

17. By December 27, 1968, the partnership, through Mr. Chapman, had developed a purchasing plan which outlined how many head of cattle it would feed and pursuant to which feeding would occur in the general locations of California and the Omaha, Nebraska area.

18. Mr. Chapman decided to feed some of the cattle in Omaha in order to avoid the partnership's complete dependence on its California markets. He preferred Omaha because of the low price of feed and its increasing packing plant capacity.

19. Mr. Chapman hoped actually to feed the partnership's cattle in Oakland, Iowa, just across the river from Omaha. Oakland had the closest feedyards but only limited capacity for grain storage. When he bought grain in December 1968 in Omaha, he realized that he would have to pay a transportation differential to transfer it to the feedyard in Oakland.

20. Whittier Cattle Company, acting as agent for the partnership, purchased cattle for the partnership. The first lot of 573 head of cattle of the total of 4,268 head was delivered on or about January 15, 1969, and the last on July 28, 1969:

January 15, 1969	573 head
January 17, 1969	124 head
January 23, 1969	92 head
March 24, 1969	100 head
March 28, 1969	121 head
April 21, 1969	146 head
April 22, 1969	116 head
April 24, 1969	248 head
May 23, 1969	352 head
May 26, 1969	372 head
May 28, 1969	279 head
June 2, 1969	244 head
June 5, 1969	187 head
June 20, 1969	1,113 head
July 10, 1969	170 head

July 14, 1969	10 head
July 28, 1969	21 head
	4,268 head

It took approximately 2 weeks following purchase for the various lots of cattle to be delivered to feed lots utilized by the partnership.

21. The partnership encountered delays in obtaining cattle in the midwest because of the need to revise its sources of credit and because of adverse winter weather.

22. Mr. Chapman usually placed stock in the feedyard nearest the elevator where his grain was stored (in this case a feedyard at Oakland, Iowa) and then was prepared to change feeding locations in response to more advantageous opportunities.

23. During calendar year 1969, the partnership acting through Mr. Chapman made the following transactions in cattle feed:

(a) On April 22, 1969, the partnership exchanged 44,000 bushels of No. 2 yellow corn located at Omaha, Nebraska, for the same amount of No. 2 yellow corn delivered to an Oakland, Iowa, feedyard. The partnership paid a transportation differential of $2,640 on the exchange;

(b) (i) In 1969, the partnership decided for the first time to feed cattle at Harrington Feed Yard in Grand Island, Nebraska. Mr. Chapman made this decision in response to what he thought were better economic arrangements available in Grand Island;

(ii) To transfer feed to that location, the partnership first sold 1,523 tons (54,400 bushels) of No. 2 yellow corn to Cargill, Inc., Omaha, Nebraska, receiving $1.24¾ per bushel. The partnership paid to Cargill a storage charge of $1,077 on this corn, representing .0036 cents per bushel per day;

(iii) The partnership then on June 2, 1969, obtained 1,540 tons of No. 2 yellow corn in Grand Island, Nebraska, from Turner Grain Company and Grand Island Elevators, Inc., at a cost of $67,100, at a cost of $1.22 per bushel for the 55,000 bushels comprised in the 1,540 tons; and

(iv) Although the record is unclear as to the exact sequence of events, the sale of this corn back to Cargill and the purchase of replacement feed in Grand Island was apparently accomplished by returning the original warehouse receipts to Cargill and then accepting delivery (of the new grain from Turner and Grand Island Elevator) in Grand Island. The exchange of warehouse receipts to obtain grain in desired locations is a common practice in the industry.

One invoice accompanying the transaction indicated that "we swapped the 54.4 m. bushels of grain we had at Cargill, Omaha, for this corn by selling it W/Rs back to Cargill and buying corn delivered to this feed lot."

24. Because the 1969 transactions involved exchange and sale of some of the grain first bought in 1968, not all the feed originally purchased by the partnership was consumed by its cattle. After the partnership obtained substitute feed in Oakland and Grand Island, however, its cattle consumed amounts of this feed roughly equivalent to the original purchases. In California, 145 tons of milo were not consumed and eventually sold to the Wheatheart Cattle Feeders. Also, 220 tons (7,875 bushels) of No. 2 corn were not consumed and were sold in 1970 to the Oakland Feed Yard.

25. When Vanderbilt No. 2 made the decision to purchase grain prior to December 31, 1968, all concerned were aware that the amount expended for grain would be a deductible expense on the partners' federal income tax returns for 1968.

The Taxpayers' Income Tax Returns

26. As a result of its business transactions, the partnership filed information returns with the Internal Revenue Service in 1968, 1969 and 1970. These returns may be summarized as follows:

	Gross Profits	Deductions	Net Profit
1968	—	$311,548 (from purchase of grain)	($311,548)
1969	$271,936 (from sale of cattle)	$130,340 (including 59,429 for more grain)	$141,596
1970	$104,379 (from sale of cattle and feed)	$46,424 (including 29,875 for more grain)	$57,955

27. (a) According to the taxpayers' amended joint return for 1968 they had income from the following sources:

Dividends	$17,587
Interest	4,993
Rental property	5,902
Estate/trust	17,820
Operation of hobby shop	3,959
Sale or exchange of property	23,948
Trustee fee	1,800
Total	$76,009
Partnership (Vanderbilt No. 2) Loss	($33,959)
Adjusted Gross Income	$42,051

After deductions and exemptions their 1968 taxable income was $26,865.

(b) In 1969, according to the taxpayers' joint income tax return, the taxpayers' sources of income were as follows:

Dividends	$ 9,937
Interest	3,018

Operation of hobby shop	817
Sale/exchange of property	15,880
Rental property	3,976
Trust income	19,670
Trustee fee	1,800
Loss from partnership (other than Vanderbilt No. 2)	(17,779)
Loss from oil well investment expenses	(48,333)
Total	(11,014)
Partnership (Vanderbilt No. 2) Profit	15,439
Adjusted Gross Income	$ 4,423

After deductions and exemptions they reported a non-taxable income for 1969.

(c) In 1970, according to the taxpayers' joint income tax return, the taxpayers' sources of income were as follows:

Dividends	$ 2,614
Interest	3,206
Operation of hobby shop	1,917
Sale or exchange of property	(1,000)
Rental property	4,517
Trust income	19,810
Trustee fee	1,800
Partnership income (other than Vanderbilt No. 2)	615
Loss from oil well investment	(29,485)
Total	$ 3,994
Partnership (Vanderbilt No. 2) Profit	6,345
Adjusted Gross Income	$10,338

After deductions and exemptions their taxable income was zero (and actually a deficit of $518).

The Cattle Feed Market Structure

28. In making management decisions for the partnership, Mr. Chapman consulted United States Department of Agriculture

(USDA) publications and reports prepared by various commodity brokers. He also talked by telephone with the Department of Agriculture officials responsible for forecast work.

29. In November 1968, regularly issued USDA publications contained the following supply and demand estimates as to the grain which would be available for feeding:

(a) The supply of available feed corn would be 5.6 billion bushels, an amount 1 percent larger than the total supply available in 1967/68. Feed corn production for 1968 was estimated to be down 282 million bushels to 4.44 billion bushels. This represented a decline of approximately 6.35 percent. The drop in production was more than offset by the increase of 323 million bushels in the carryover of corn from the 1967/68 crop;

(b) The "free" supply of feed corn available to meet demand in the market in the fall of 1968, as estimated in November 1968, was approximately 4.9 billion bushels. The "free" supply of grain is determined by adding the amount of feed corn carryover on October 1, 1968 held in private hands, 432 million bushels, to the amount of expected 1968 corn products, 4.4 billion bushels;

(c) The USDA November 1968 estimate of feed corn demand indicated that the 1968/69 demand for feed corn would be approximately 4.4 billion bushels, representing an increase in feeding activity from 1967/68. The report stated:

> Relatively low corn prices again in 1968/69 and generally favorable price ratios for livestock and poultry producers are expected to result in a little heavier feeding of corn during the present marketing year than in 1967/68. Domestic consumption may be around 50 to 100 million bushels above last year's. Exports of corn may be a little above the 634 million bushels in 1967/68 (table 2). This would bring the total utilization in 1968/69 to over 4.4 million bushels — equal to or possibly a little above the 1968 production. In this

event the carryover into 1969/70 would be around 1.1 billion bushels, or close to the carryover on October 1, 1968.

(d) The USDA estimate of grain production for 1968 indicated that the 1968 feed corn production would "probably * * * about take care of domestic use and exports. Not much change in carryover * * * [was] in prospect for the close of the 1968/69 marketing year"; and

(e) The USDA November 1968 estimate predicted that feed corn prices were expected to rise seasonally during the winter and spring of 1968/69.

30. Vanderbilt No. 2's managing agent customarily watched the futures market.

31. The closing prices for May corn futures at the Chicago Board of Trade were on the indicated dates as follows:

Date	Price Per Bushel
November 15, 1968	1.24¼
November 30, 1968	1.23
December 15, 1968	1.22
December 31, 1968	1.20¾
January 15, 1969	1.21
January 31, 1969	1.20¼

These prices reflected a fairly flat futures market throughout the period listed.

32. Prices quoted on the grain futures market represent the price at which a willing buyer will buy and a willing seller will sell grain to be delivered at some future date. On the date that a futures contract expires, which is usually the 20th of a month, the futures contract price tends to be the same as the cash market price for that day.

33. Grain prices differ somewhat from one geographic location to another because of differences in delivery costs and lack of availability of grain at different locations.

34. Omaha, Nebraska, is considered a representative grain market. It is situated in the western corn belt and is surrounded by major corn producing areas. Mr. Chapman believed Omaha to be one of the lowest price base markets in which to buy No. 2 yellow corn.

35. The Grain Market News, published weekly by the United States Department of Agriculture, reports cash grain closing prices, F.O.B. track, for various grains for various markets throughout the country. The prices quoted in the Grain Market News for No. 2 yellow corn at Omaha from October 3, 1968 through May 31, 1969, were as follows:

Date	Price Per Bushel
10-3-68	1.09-1.16
10-10-68	1.12-1.20
10-17-68	1.10-1.21
10-24-68	1.13-1.23
10-31-68	1.09-1.18
11-7-68	1.15-1.23
11-14-68	1.15-1.22
11-21-68	1.15-1.22
11-27-68	1.16-1.22
12-5-68	1.13-1.19
12-12-68	1.15-1.20
12-19-68	1.14-1.19
12-26-68	1.15-1.20
1-2-69	1.15-1.20
1-9-69	1.20-1.23
1-16-69	1.20-1.22
1-23-69	1.19-1.22
1-30-69	1.19-1.23
2-6-69	1.18-1.21
2-13-69	1.18-1.22
2-20-69	1.18-1.21
2-27-69	1.17-1.21
3-6-69	1.18-1.24
3-13-69	1.18-1.25
3-20-69	1.18-1.25

Date	Price Per Bushel
3-27-69	1.18-1.25
4-3-69	1.20-1.26
4-10-69	1.21-1.26
4-17-69	1.23-1.28
4-24-69	1.24-1.28
5-1-69	1.26-1.31
5-8-69	1.28-1.33
5-15-69	1.27-1.30
5-22-69	1.27-1.33
5-28-69	1.25-1.28

36. When the partnership purchased No. 2 yellow corn at Omaha on December 27, 1968, it paid $1.23 per bushel (finding 10(a)). The difference between this price and the prices — $1.15 — $1.20 — quoted in the Grain Market News for December 26, 1968 (preceding finding), is explained in part by the fact that the partnership purchased warehouse receipts for its No. 2 yellow corn. Warehouse receipts usually sell at a premium of one to five cents per bushel because they contain an absolute guarantee by the grain dealer that the quality of the grain purchased will be precisely as stated in the warehouse receipt.

Plaintiffs' Reasons for Purchasing in 1968

37. Mr. Chapman testified that his reasons as operating manager of Vanderbilt No. 2, in charge of purchasing feed and cattle, for purchasing feed grain for the partnership prior to the year end in 1968 were as follows:

(a) His studies at the time showed that in 8 out of 10 years, the cheapest time of year to buy feed was in the fall, and that prices were significantly higher the following spring or summer;

(b) To fix the price;

(c) To bargain for delivery terms and position (location) of the feed because he was concerned about having enough grain in

the locations where he wanted it the following spring and summer;

(d) To get quantities he might not be able to obtain otherwise;

(e) In his opinion, the market price of grain was depressed at the time he purchased the grain for the partnership and the grain market was bullish; and

(f) By buying at that time he was able to negotiate favorable storage rates. In fact he completely eliminated storage charges in some instances and incurred only partial charges in others.

Plaintiffs' Opinion Testimony

38. Plaintiffs' expert witness was Mr. Leon Miller. Mr. Miller is a vice-president of a Southern California marketing firm which owns a cattle feedyard and also engages in trading of grain commodities. He testified that from 1966 to 1970 the bulk of the cattle feeding industry in Southern California bought its grain in advance. Mr. Miller gave several economic justifications for such advance purchasing as follows:

(a) To protect against a spectacular increase, or any kind of increase in the market place;

(b) To know exactly what the ultimate close-out cost of grain on the cattle is going to be when they are finished;

(c) Historically, if grain is purchased in advance and stored, in 9 out of 10 years the market will increase significantly more than the storage costs; and

(d) In times of depressed markets, when grain is purchased on warehouse receipts, it is common practice for no storage charges to be assessed to the buyer for several months and it is not uncommon for no storage charges to be assessed.

Defendant's Opinion Testimony

39. Mr. Jack Ross, an expert witness on behalf of defendant, has been a feed grain analyst with the USDA Economic Research Service since 1962. Mr. Ross is a specialist in domestic markets. He based his testimony in part on the various USDA feed grain and livestock summaries published from 1967 through 1969 to which he was a substantial contributor.

40. Mr. Ross testified that:

(a) During the mid- to late 1960's the goal of the USDA's grain supply program was to bring the supply of feed grain in line with the demand for feed grain through the operation of various price stabilization programs, including paying farmers for acreage not planted;

(b) Corn is by far the most dominant feed grain;

During the mid- to late 1960's, it accounted for roughly 70-75 percent of the total feed grain produced in this country. Because of corn's dominance, the price of other feed grains such as sorghum, oats and barley tend to follow the price changes of corn;

(c) As a result of the 1968 feed corn harvest and the carryovers of feed corn stocks from the previous year, approximately 5.6 billion bushels of feed corn were available to meet the market demand for feed corn, estimated to be 4.5 billion bushels during the 1968/69 feeding season. The supply would be ample for the increased demand;

(d) The 1968/69 feed corn supply of 5.6 billion bushels was approximately 1 percent greater than the 1967/68 supply of feed corn;

(e) Though the USDA statistics are "probably [the] subject [of] some discussion" and "may be off some," they "are still the best numbers in the world";

(f) The USDA November 1968 estimate of expected 1968 corn production was a very accurate estimate. Its accuracy is reflected in the fact that the December 1968 final revision of the estimate of 1968 feed corn production reflected only a small drop in estimated production. The relative insignificance of this fluctuation was borne out by the fact that the December 1968 revision produced no significant changes to the prices of corn on the futures market;

(g) A review of all the market indicators available in the fall of 1968 indicated to the witness that the supply of feed corn available would be fully adequate to meet the market demand requirements for 1968/69. It was further believed that the demand requirements could be met out of the 1968 production and the carryover of "free" grain held privately and not in Government stocks, and that the carryover of corn would not change significantly from 1967/68 to 1968/69;

(h) If there had been a drastic upward fluctuation in feed corn prices in late 1968 or 1969, the USDA controlled sufficient reserve stocks of feed corn, 714 million bushels, which could have been offered to the market to stabilize the price of feed corn;

(i) In his opinion the feed corn market would not experience any runaway trend in prices during the 1968/69 year;

(j) A normal seasonal price rise of approximately 15 cents per bushel was expected for the 1968 feed corn crop. This 15-cent rise in price is primarily attributable to storage costs. Some other factors are also important, including insurance, the cost of borrowing money and the improved quality of the corn resulting from loss of moisture when it is properly stored; and

(k) In his opinion, the stability of the feed corn market meant that the United States livestock feeding industry had no reason to buy feed corn, or any other grain, except on an as-needed basis in late 1968 and 1969. The market was very stable and the feeding

industry should not have found it necessary to buy huge quantities of grain in advance of feeding.

41. Mr. Ross had never bought or sold grain nor had he ever fed or purchased grain for any cattle.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which the court adopts and which are made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are entitled to recover, and judgment is entered to that effect, with the determination of the exact amount of recovery to be made in futher proceedings under Rule 131(c).

Supreme Court, U. S.
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No. 78-622

In the Supreme Court of the United States

OCTOBER TERM, 1978

ROBERT E. and JANE ANN HARDEN CLEMENT, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

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MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question presented in this federal income tax case is whether the decision below correctly held that petitioners could not deduct in 1968 their pro rata share of amounts that their partnership expended in December of that year to purchase cattle feed for the subsequent taxable year, where such a deduction would materially distort the partnership's income.

The pertinent facts are undisputed and may be summarized as follows: Petitioners' limited partnership was organized under an agreement filed December 1, 1968, to engage in the business of buying, feeding, and selling cattle. The partnership engaged in only one business transaction in 1968. On December 27, 1968, before the partnership had acquired any cattle, it purchased $311,548 worth of grain warehouse receipts. On its 1968 tax return, the partnership reported this grain expenditure as a business expense and thus claimed a net loss of $311,548 for that year. Petitioners, in turn,

reported their ratable portion (10.9%) of this claimed loss on their 1968 federal income tax return (Pet. App. B-2 to B-6).

On audit, the Commissioner disallowed petitioners' deduction on the ground that it distorted their income for 1968. In this refund suit, the Court of Claims upheld the Commissioner's position, concluding that if petitioners were permitted to "tak[e] the deduction in 1968 instead of 1969 [it would cause] * * * a material distortion of income * * * " (Pet. App. B-17). It therefore ruled that the Commissioner had acted within the authority granted him by the Internal Revenue Code to ensure that taxpayers' methods of accounting clearly reflect their actual incomes when he disallowed the claimed 1968 deduction (Pet. App. A-18 to A-21).

1. The Court of Claims correctly held that petitioners could not deduct the cost of cattle feed for 1968. As this Court noted in *United States* v. *Catto*, 384 U.S. 102, 114 (1966), "Congress has granted the Commissioner [of Internal Revenue] broad discretion in shepherding the accounting methods used by taxpayers." See *Lucas* v. *American Code Co.*, 280 U.S. 445 (1930). Pursuant to Section 461(a), the general Code provision governing the timing of tax deductions, the proper year for a deduction permitted by the Code depends upon the "method of accounting used in computing taxable income."[1] Thus, while Treasury Regulations, Section 1.461-1(a)(1), generally provide that cash method taxpayers such as petitioners shall deduct expenses during the taxable year

[1]Contrary to petitioners' contention (Pet. 12), the Court of Claims did not disregard Treasury Regulations, Section 1.162-12(a). While that provision identifies livestock feed as a deductible expense, Section 461 and the Regulations issued thereunder specifically control the timing of otherwise qualified deductible items. The question of the proper timing of a deduction is determined by the taxpayer's method of accounting, which, in turn, must clearly reflect the taxpayer's income pursuant to Section 446(b).

in which they were paid, the Regulations further state that even a cash basis taxpayer may not claim an immediate deduction for all deductible expenditures. For example, if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such expenditure may not be deductible, or may be deductible only in part, during the taxable year in which it is paid. See Section 263. This limitation is grounded on the Commissioner's discretionary authority to require that a method of accounting clearly reflect income. 26 U.S.C. 446(b). *Sandor* v. *Commissioner*, 536 F. 2d 874 (9th Cir. 1976); *Burck* v. *Commissioner*, 533 F. 2d 768 (2d Cir. 1976); *Commissioner* v. *Boylston Market Ass'n*, 131 F. 2d 966 (1st Cir. 1942). See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A161 (1954); S. Rep. No. 1622 83d Cong., 2d Sess. 305 (1954).

Here, petitioners do not challenge the Court of Claims' conclusion that the payment for grain warehouse receipts on December 27, 1968, resulted in the creation of an asset having a useful life extending substantially beyond the close of the taxable year ending December 31, 1968 (Pet. App. A19). Nor do they contest the court's finding that a failure to prorate the grain expense deduction over the period of actual use would result in a material distortion of income. Given these findings, which are fully supported by the record, the court below was obliged but to sustain the Commissioner's determination that petitioners could deduct the feed grain expenditure when the grain was used and not when it was purchased. Rev. Rul. 75-152, 1975-1 Cum. Bull. 144; *Stice* v. *United States*, 540 F. 2d 1077 (5th Cir. 1976).

2. Contrary to petitioners' contention (Pet. 9-11), the decision below does not conflict with *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281 (1944). Indeed, that case supports the Commissioner's determination here. As the Court noted in that case (*id.* at 285), the

Commissioner's authority to require that deductions be taken at such times as to produce "undistorted" income reports was designed to prevent the creation of artificial losses by the prepayment of expenses applicable to the production of future income.

Cravens v. *Commissioner*, 272 F. 2d 895 (10th Cir. 1959), upon which petitioners rely (Pet. 11-12), is likewise distinguishable. Unlike this case, the court in *Cravens* did not find that the allowance of an immediate deduction for the feed grain there involved would create a material distortion of income. Indeed, as the court below observed (Pet. App. B-8), *Cravens* turned on the facts that there was a drought and that cattle feed was in short supply so that the taxpayer's purchase assured that he would receive preferential delivery of feed (*id.* at 899). To the extent that *Cravens*, standing alone, might be subject to a broader interpretation, the Tenth Circuit's later decision in *Cattle Feeders Tax Committee* v. *Shultz*, 504 F. 2d 462 (1974), indicates that it should not be so interpreted. In *Cattle Feeders*, the Tenth Circuit refused to enjoin enforcement of a published revenue ruling (*id.* at 463 n.1) that barred immediate deduction of feed costs when such a deduction would distort income. In so holding, the court observed that Sections 446 and 461(a) empower the Commissioner to compute taxable income in a manner that will clearly reflect income (*id.* at 465-466).

Finally, contrary to petitioners' assertion (Pet. 7-9), the decision below does not require all farmers to tie their deductions for feed grain expenditures to the period in which that feed grain is consumed. It would require such treatment only where, as in the present case, the facts

show that the claiming of the deduction in the year of the expenditure or the accrual would result in a distortion of income.[2]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

JANUARY 1979

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[2]The Tax Reform Act of 1976 in large part eliminates the problem presented by this case for taxable years beginning after December 31, 1975. Under Section 464, added by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1536, certain farming syndicates may claim deductions for "amounts paid for feed, seed, fertilizer, or other similar farm supplies" only during the taxable year in which they were used.

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